MITCHELL | HAMLINE School of Law

William Mitchell Law Review

Volume 14 | Issue 4 Article 1

1988

Developing a Theory of Damage Recovery Taxation

Jennifer J. S. Brooks

DEVELOPING A THEORY OF DAMAGE RECOVERY TAXATION

JENNIFER J.S. BROOKS†

The tax treatment of personal injury damages has developed without a coherent framework for decision-making. I.R.C. Section 104 excludes from income any damages paid on account of "personal injuries," but does not define the term. The ambiguity has produced conflicting court decisions and IRS reversals of longstanding positions. Reference to income theory for the meaning of "personal injuries" suggests that the appropriate inquiry is whether the recovery replaces lost human capital and imputed income from human capital, which are normally enjoyed tax-free. If so, the state courts' reference to lost earnings can be regarded as a measure of the loss rather than a classification of it. Recent tax decisions, although not stated in terms of income theory, have been consistent with the idea that replacements for nonincludible human capital values ought to be received tax-free. Professor Brooks recommends the explicit use of human capital as a touchstone for determining whether a recovery is for "personal injuries."

† Associate Professor of Law, William Mitchell College of Law. B.A., Wake Forest University, 1973; J.D., Catholic University, 1978; LL.M., Harvard Law School, 1986.

INTRODUCTION

The law of taxation of damages has suffered from the lack of any coherent theory for decision-making.[1] Although the Internal Revenue Code has provided since 1918 that personal injury damages are to be excluded from income,[2] vagaries of interpretation of the terms "personal injury" and "damages" have caused confusion and unpredictibility. Disagreements between the United States Tax Court and the Courts of Appeals,[3] and IRS reversals of longstanding positions,[4] may to a substantial extent be attributable to the absence of a framework for analysis of damage recovery issues. There can be no pretense that the legislative history of the 1918 law offers a rationale for the treatment of personal injury damages.[5]

The scope of Section 104(a)(2), which expressly excludes from gross income the amount of a personal injury damage award or settlement, is a question that ought to be resolved by reference to income theory.[6] A system of taxation that intends

1. *See* Henry, *Torts and Taxes, Taxes and Torts: The Taxation of Personal Injury Recoveries*, 23 HOUS. L. REV. 701, 701 (1986).

2. *See* I.R.C. § 104(a)(2), 26 U.S.C. § 104(a)(2) (1986) (the current version of the exclusion for personal injury recoveries). References in this paper to the Internal Revenue Code of 1986 (as amended), 26 U.S.C., will hereinafter be to the Code section, as in "Section 104(a)(2)."

3. *See, e.g.*, Roemer v. Commissioner, 716 F.2d 693, 701 (9th Cir. 1983), *rev'g*, 79 T.C. 398 (1982).

4. *See, e.g.*, Rev. Rul. 84-108, 1984-2 C.B. 32 (revoking Rev. Rul. 75-45, 1975-1 C.B. 47).

5. Congress may have been codifying what it thought to be the law in 1918. "Under the present law it is doubtful whether . . . damages received on account of injuries or sickness are required to be included in gross income." H.R. Rep. No. 767, 65th Cong., 2d Sess. 9-10 (1918).

6. "Serious thought about personal income tax policy has come to be dominated by an ideal in which taxable income is set equal to total personal gain or accretion, without distinctions as to source or use. . . . [This ideal is called] an accretion-type personal income tax." Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1113 (1974). Income theory (including consideration of both the accretion-type and the consumption-type personal income tax) "can be made to serve as a frame of reference for evaluating the existing tax and for generating . . . proposals for improvement." *Id.* at 1178; *see also* N. KALDOR, AN EXPENDITURE TAX 55 (Allen & Unwin 1955) ("the aim of theory is to lay down clear and consistent

to impose tax based on net income assumes some reasonable theoretical definition of income that can be used as a guide to determine individual taxable capacity. The "aim of theory is to lay down clear and consistent general principles . . . on the basis of which the popular use of concepts can be criticized."[7] Interpretation of the tax code in light of income theory promotes internal consistency, more accurate income measurement, and horizontal equity. New cases always arise; the decided cases are not likely to be precisely on point. A reasonable theoretical framework can serve as a starting place for analysis. This article uses income theory to begin developing a theory of damage recovery taxation.

In short form, the idea is that payments to compensate people for the loss of value they otherwise receive tax free should also be tax free. This approach is not original,[8] but has not been much studied. It does not compel a radical departure from current law — on the contrary, it seems to work to explain and reconcile the broader trends. It has the advantage of not being cast in doctrinal terms (as, for example, a rule that makes results turn on whether the plaintiff proceeded in tort or contract). Although the idea that substitutes for tax-free values are themselves tax free is simple, its simplicity does not eliminate the need for careful analysis of difficult issues. The main advantage of the theory, however, is that it encourages resolution of questions on a basis expressly consistent with income theory, yet retains the flexibility to accomodate social policy goals.

As the statute is written, the term "personal injury" must be given content so that courts can decide what recoveries are excludible. The courts' current view is that state law definitions

---

general principles from which theoretically correct definitions can be drawn and on the basis of which the popular use of concepts can be criticized").

7. N. KALDOR, *supra* note 6, at 55.

8. *See* U.S. v. Kaiser, 363 U.S. 299, 311 (1960) (Frankfurter, J., concurring); ANDREWS, BASIC FEDERAL INCOME TAXATION 157 (3rd ed. 1984); Henry, *supra* note 1, at 728; Cochran, *Should Personal Injury Damage Awards Be Taxed?* 38 CASE W. RES. 43, 48-49 (1987) (arguing for inclusion of damage awards even if they do substitute for nonincludible values); Frolik, *Personal Injury Taxation as a Tax Preference*, 37 ME. L. REV. 1,15-23, 40 (1985) (arguing that cash payments for damage to zero-basis assets ought to be includible because of the increased ability to pay tax); Yorio, *The Taxation of Damages: Tax and Non-Tax Policy Considerations*, 62 CORNELL L. REV. 701, 702-03, 713-14 (1977) (concluding that exclusion of cash recoveries on the grounds that the money replaces values normally enjoyed tax-free eliminates the zero basis issue).

determine excludibility. Reliance on state law inevitably produces inconsistent treatment of taxpayers, causing horizontal inequity and in some cases inaccurate measurement of income. Moreover, decision-makers have limited the exclusion to damages from tort or tort-like claims (as defined in state law), promoting a tort/contract distinction not helpful at the margin — as, for example, in cases involving fraudulent conduct that could support a claim in either tort or contract. Where there is a mix of claims, some lying in tort and some in contract, it becomes necessary to identify the components of the recovery and allocate the award between excludible and includible amounts (or refuse to allocate where the parties have not). There is a likelihood of horizontal and vertical inequity when treatment of taxpayers depends on how well-advised they are in making their initial claims, or in drawing up their settlement agreement, or in choosing to sue in a particular state.

No theory can be completely free from some basic tensions. The factual problem of identifying excludible components of a recovery arises from the goal of accurate income measurement. But any requirement of allocation between includible and excludible parts of an award suffers from difficulties of implementation and the risk that similar taxpayers will be treated differently; thus, the goal of accurate measurement competes with the need for simplicity and fairness. A broad rule of includibility or excludibility is more easily administered, and might treat more evenly taxpayers who have recovered damages, but may not measure income accurately and may be inequitable vis-a-vis taxpayers who have income that is easy to include or exclude.

At a minimum, however, it ought to be possible to free questions of damage recovery taxation from reliance on state law. Although the idea that excludible damages arise from "tort or tort-like claims" has merit as a rule of thumb, it should be seen as only a rough surrogate for the determination whether an amount is paid as a substitute for value that usually is received tax free. The courts or Congress ought to adopt rebuttable presumptions as to the excludibility of some recoveries, first to establish clearer guidelines and second to ease the difficulties of characterization that pervade this area of the law. To diminish the allocation problems that remain, it may help to use a "predominant nature" rule in identifying a recovery as excludible or includible.

The first part of this paper suggests a theoretical framework for analysis of damage recovery taxation. The second part examines current law in light of that approach. The conclusion makes some specific recommendations for change. Again, the basic idea is that income substitutes ought to be includible, and substitutes for nontaxable values ought to be excludible. Application of this idea leads to results not radically different from those produced under existing law, but with greater promise of predictability and fairness.

I. THEORY: RATIONALE FOR THE EXCLUSION OF DAMAGE RECOVERIES

The federal income tax is designed to impose tax on net income. Its mechanics are the identification of "gross" income and the deduction, *inter alia*, of amounts representing the cost of producing that income.[9] The 1938 Haig-Simons economic definition of income is similar, but with different mechanics: annual income is the market value of personal consumption plus net accumulation (the net change in worth of the taxpayer's assets).[10] Some of the tax code's deductions arrive at an amount like the "net change" part of the Haig-Simons definition, and other deductions may be thought to adjust for expenditures not involving personal consumption.[11] The Haig-Simons definition of income is referred to as the "accretion" model of income because it includes annual increases in the value of assets. The tax law, said to be accretion-based, is less inclusive than the Haig-Simons definition because the realization requirement bars inclusion of accretions that have not been realized by a sale or exchange. Further, some tax code rules — for example, the deduction of contributions to retirement plans — may shift the measure of income more toward personal consumption than accretion. Nonetheless, both the tax law and the accretion model define income as no greater than net accumulation plus the market value of personal consumption.

The tax code defines gross income, in Section 61, to include

9. *See* I.R.C. § 61 (gross income); I.R.C. § 62 (deductions from gross income).

10. H. SIMONS, PERSONAL INCOME TAXATION (1938), relies on earlier analysis by Haig. *See* Haig, *The Concept of Income—Economic and Legal Aspects, reprinted in* FEDERAL INCOME TAX I 7 (R. Haig, ed. 1921). *See also* N. KALDOR, *supra* note 6, at 70.

11. For a careful analysis of the tax code's similarities to and deviations from an ideal accretion model, see Andrews, *supra* note 6.

"income from whatever source derived." Any receipts that better the taxpayer's economic position may be thought includible in gross income: not only earned income but also windfalls — for example, lottery prizes and gambling winnings. In *Commissioner v. Glenshaw Glass Co.*,[12] the United States Supreme Court said that punitive damages for fraud and the punitive two-thirds of antitrust damages were windfalls that the corporate taxpayer should include in income because the amounts were "undeniable accessions to wealth, clearly realized, and over which the taxpayer [had] complete dominion."[13] The *Glenshaw* notion of "accessions to wealth" as income is consistent with the economic concept of income. Windfalls like those in *Glenshaw* should be includible in theory,[14] and are in practice.

The tax code has been interpreted to require that substitutes for ordinary income also be included in gross income. For example, a landlord who received $140,000 from a tenant for cancellation of the lease ten years before the end of the lease term was required to include the payment in income because it was a substitute for rent.[15] The "substitute for ordinary income" idea has motivated courts, the IRS, and taxpayers to treat as includible the one-third of antitrust damages that substitutes for the plaintiff's lost profits.[16] So well established is this principle that it was not an issue in the 1955 *Glenshaw Glass* decision; the taxpayer had reported one-third of the antitrust settlement as ordinary income.[17]

Despite the broad language of Section 61, so-called "imputed" income usually has not been includible. "Imputed income" is generally thought of as the market value of services a taxpayer performs for herself, or the annual rental value of consumer durables a taxpayer owns. There is no specific statutory provision excluding imputed values from gross income, and no judicial decision so holding, but there has been wide acceptance of the view that this form of income should not be

12. 348 U.S. 426 (1955).

13. *Id.* at 431.

14. *See* N. KALDOR, *supra* note 6, at 68-69.

15. Hort v. Commissioner, 313 U.S. 28 (1941).

16. *See Glenshaw Glass*, 348 U.S. 426 (1955) (taxpayer reported one-third of antitrust damages as ordinary income); *see also* Raytheon Production Corp. v. Commissioner, 144 F.2d 110 (1st Cir.), *cert. denied*, 323 U.S. 779 (1944).

17. *See Glenshaw Glass*, 348 U.S. at 427.

taxable.[18] Because imputed income may measurably improve a taxpayer's economic position, there has been debate about the inequity of failing to tax the annual rental value of an owner-occupied home or other consumer durables like cars and boats.[19] It has been demonstrated that failure to include imputed income from home ownership discriminates against renters who have equivalent monetary income but must pay nondeductible rent.[20] Exclusion of other items of imputed income, for example, the value of services the taxpayer performs for himself, or the value of a taxpayer's leisure time, has provoked less controversy.[21] Problems of administrability and the absence of any real risk of distortion in economic conduct weigh against the inclusion of most imputed values, and in some situations the unavailability of imputed deductions mitigates the benefit from noninclusion of imputed income.[22]

Because the income tax is imposed on net income, specific sections of the tax code exclude expenses, cost, and returns of capital from income. For example, Section 1001 defines "gain" on the sale of property to exclude that part of the sale proceeds representing a return of the taxpayer's "basis" or cost for the property; Section 72, which governs the taxation of annuity income, excludes the part of each annual payment that represents a return of the taxpayer's annuity contract pre-

18. *See* Marsh, *The Taxation of Imputed Income*, 58 POL. SCI. Q. 514 (1943); *see also* McIntyre & Oldman, *Taxation of the Family in a Comprehensive and Simplified Income Tax*, 90 HARV. L. REV. 1573, 1607-24 (1977).

19. *See, e.g.*, Bradford and U.S. Treasury Department, Blueprints for Tax Reform 6, 108-10 (Tax Analysts 1984) [hereinafter *Blueprints*]; McIntyre & Oldman, *supra* note 18, at 1609.

20. *See* KLEIN BITTKER, STONE, FEDERAL INCOME TAXATION 122-25 (discussion of imputed income from home ownership); 125-27 (imputed income from services); 127-28 (imputed income from leisure) (7th ed. 1987). The exclusion of imputed income from home ownership, particularly when home mortgage interest is deductible, creates significant inequity and promotes substantial distortion in economic conduct. That distortion — buying rather than renting — is not only tolerated but indeed seems to be encouraged as a matter of generally accepted social policy. The significance of new home starts as a measure of national economic well-being suggests, moreover, that current tax treatment of home ownership is deeply entrenched.

21. *Id. See also* H. SIMONS, *supra* note 10, at 53, 111-12. Some sections of the tax code may be influenced by imputed income issues. For example, Section 21, which allows a credit for child care costs "necessary for gainful employment," may be viewed as a rough balancing of noninclusion of the imputed income from one parent's services in the home with inclusion of all the monetary income of a two-earner family. *See generally* Marsh, *supra* note 18, at 517.

22. *See* Halperin, *Interest in Disguise: Taxing the Time Value of Money*, 95 YALE L.J. 506, 516-17 (1986).

mium. These provisions can be thought of as giving effect to the "net accumulation" part of the Haig-Simons definition; they result in the inclusion of only the accretion to the taxpayer's wealth (measured in the year the accretion is realized). Other deductions from gross income, for example the Section 162 business expense deduction, serve not only to restrict "income" to net accretions, but also to reflect the fact that some expenses are not for personal consumption. For example, depreciation deductions are assumed to reflect net declines in the value of business assets, and deductions for business travel are assumed to represent nonpersonal expenditures. Both the accretion model and, in most instances,[23] the tax law require that returns of tax-paid basis be excluded from net income.

A. *Damage Recoveries as Returns of Basis*

Personal injury damage awards, which Section 104(a)(2) specifically excludes from gross income, have often been analogized to returns of capital.[24] An argument might be made that a taxpayer who has lost a limb in an automobile accident had a cost for the limb measured by the proportionate cost of food, clothing, and shelter that the taxpayer paid to maintain the limb. This argument makes sense if (1) costs allocable to the lost limb can be proved, and (2) the costs were paid with after-tax dollars. The problems of proof would be insurmountable if an exact accounting were required,[25] but proof would be

23. An exception is the sale of an income stream apart from the underlying asset. *See* I.R.C. § 1001(e).

24. *Glenshaw Glass*, 348 U.S. at 432 n.8; Starrels v. Commissioner, 304 F.2d 574, 576 (9th Cir. 1962) (collecting cases and rulings); Solic. Mem. 1384, 1920-2 C.B. 71,72. *See* Stephan, *Federal Income Taxation and Human Capital*, 70 VA. L. REV. 1357, 1391-95 (1984); Cochran, *supra* note 8, at 45-46; Frolik, *supra* note 8, at 18; Yorio, *supra* note 8, at 711-13.

25. *Cf. Raytheon*, 144 F.2d 110, 114 (1st Cir.), cert. denied 323 U.S. 779 (1944) (corporate taxpayer taxed on settlement because it failed to prove basis in the business goodwill destroyed by antitrust violations). Because the taxpayer bears the burden of proof, and must substantiate cost basis, a special rule permitting use of statistical data would be necessary if cost basis were viewed as the only grounds for excluding damage recoveries from income. The tax code does not allow expense deductions for business, family, or personal expenses. *See* I.R.C. § 262. The amounts a person spends on self-maintenance (payments for food, clothing, shelter, and medical care) can be thought of as in large part personal expenditures and, in small part, the current cost of producing income. The portion connected with income production ought to be currently deductible.

possible if statistical data or a presumed cost equal to market value were accepted to show the taxpayer's cost.

The more complex question is whether self-maintenance costs allocable to the lost limb were paid with after-tax dollars, thus creating a cost basis that should be recovered tax-free. Taxpayers usually pay for food, clothing, and shelter with after-tax dollars; these are thought of as non-deductible "personal" expenses.[26] But these expenses are at least partly deductible. The standard deduction and personal exemption operate to zero-bracket people who have only subsistence levels of income. In effect, these deductions permit taxpayers to reduce gross income by amounts that might be viewed as minimum self-maintenance costs. These deductions could be thought of as the presumptive subsistence costs necessary to sustain the taxpayer as an income-producer; in other words, the deductible amounts represent the self-maintenance costs of producing income from labor. Because the cost of self-maintenance has already been deducted (at least to this minimal degree), the taxpayer does not have a tax-paid basis, part of which could be allocated to the lost limb.[27]

It could be argued that any self-maintenance costs over the minimum subsistence amounts represented by the standard deduction and personal exemption are paid with after-tax dollars and give the taxpayer a cost basis in self. But income theory classifies the monetary value of personal consumption as income. The standard deduction and personal exemption might be thought of as deductions for self-maintenance to produce income, and thus not personal consumption; amounts spent above minimum self-maintenance would be for personal consumption, and thus not properly included as basis. The

26. *See* I.R.C. § 262 (denying deductions for personal, family, and living expenses).

27. The treatment of advertising costs is analogous to a degree. Although a considerable part of the cost of advertising might be regarded as producing goodwill that adds value to a business, amounts spent for advertising are currently deductible under I.R.C.§ 162 and so may not also increase the taxpayer's basis in the business. *See* Vettel, *Should Advertising Costs Be Capitalized*?, 36 TAX NOTES 455 (1987). The difference is that all advertising costs are deductible, but not all expenses that contribute to the development of human capital. Those expenses might be presumed to add to basis; education costs are an example. *See* Stephan, *supra* note 24. *Cf.* Raytheon Production Corp. v. Commissioner, 144 F.2d 110, 114 (1st Cir.), *cert. denied*, 323 U.S. 779 (1944). The implications of *Raytheon* for basis recovery issues in the business context are pursued in Gilbertz v. U.S., 808 F.2d 1374, 1381 (10th Cir. 1987).

Haig-Simons model, by identifying two components of income, suggests that receipts are used either for accumulation or for consumption, not both. Thus, amounts spent for personal consumption would not be treated as amounts that increased the net worth of the taxpayer's assets. Because the zero bracketing amounts are arguably less than actual subsistence, there may be some part of the taxpayer's nondeductible self-maintenance that ought not be considered personal consumption. The amounts would be relatively small, however, and it is probably a reasonable simplifying assumption to say that self-maintenance costs above the zero-bracketing amounts are entirely for personal consumption.

This analysis does not hold true, however, for some expenditures beyond those for minimum subsistence. Educational expenses, for example, are thought to accumulate human capital in addition to the endowment present at birth. The cost of a college education is neither deductible nor amortizable, but seems to be other than an expenditure for personal consumption. If education is considered to enhance human capital (as opposed to some asset normally valued in market terms), the current tax treatment of educational costs makes sense; there is no current deduction because the expenses increase the value of an asset (human capital), and there is no amortization because the asset's life and value are not measured in terms that make it an appropriate object of "depreciation." But if educational expenses are paid with after-tax dollars and are not personal consumption, then there is at least some identifiable tax-paid basis in the human person. The part of a personal injury damage recovery that represents recovery for tax-paid basis ought to be excluded as a return of basis. This analysis has been pursued with some determination in the tax literature,[28] but does not seem sufficient to justify exclusion of the entire recovery for personal injury. Income theory, however, suggests other rationales that may explain the complete exclusion of personal injury damages.

B. *Damage Recoveries as Restoration*

The notion of a return or "recovery" of capital has led courts to talk about the exclusion of personal injury damages

28. *See* Stephan, *supra* note 24; *see generally* authorities cited *supra* note 8.

as justified on the grounds that they merely restore the status quo; they make the taxpayer "whole."[29] The theory is that a taxpayer who has something, loses it, and then gets it back does not have an "accession to wealth" that should be includible under *Glenshaw Glass*.[30] But this rule is too broad. There are two categories of recoveries that should be taxed: (1) substitutes for taxable income not previously received; and (2) recompense for some taxable-but-as-yet untaxed thing the taxpayer had and lost. In the first category, for example, is a payment for taxable income never received because of another's antitrust violation; the payment is includible because it substitutes for taxable income.[31] In the second category is a payment to replace something that should have been taxed when received, but (like Duberstein's Cadillac)[32] was not included in income.[33] Merely noting that a taxpayer has been restored to the status quo ante is insufficient; it is necessary to ask whether that status was a taxable one.

C. Damage Recoveries as Returns of Nonincludible Values

Excludability of compensatory recoveries makes sense if the payment is a pecuniary restoration of either (1) something the taxpayer had acquired with after-tax dollars (a recovery of basis), or (2) a nontaxable "something" the taxpayer had and lost (a return of nonincludible value). Consider an analogy to recovery for tortious conversion of plaintiff's newly-purchased graphite tennis racket. Because the plaintiff paid $400 in after-tax dollars for the racket, she has a basis of $400, and her recoveryof $400 is a nontaxable return of capital. The payment is not a substitute for ordinary income, and because it

29. *See, e.g.*, *Glenshaw Glass*, 348 U.S. at 432 n.8; Starrels v. Commissioner, 304 F.2d 574, 574 (9th Cir. 1962) (collecting cases and rulings); *cf.* Edward H. Clark, 40 B.T.A. 333 (1939), *acq.*, 1957-1 C.B. 4.

30. *Glenshaw Glass*, 348 U.S. at 426 (1955) (taxpayer reported one-third of antitrust damages as ordinary income).

31. *Id.* at 431.

32. Mr. Duberstein received a Cadillac from a business associate and, after some discussion, was required to include its value in income. Commissioner v. Duberstein, 363 U.S. 278 (1960).

33. *Cf.* I.R.C. § 111 (requiring the inclusion of items recovered in a later year if the taxpayer had derived a tax benefit, for example a deduction against other income, from the item in an earlier year); Haverly v. U.S., 513 F.2d 224 (7th Cir.), *cert. denied*, 423 U.S. 912 (1975) (high school principal who claimed charitable contribution deduction for donation of books he received free was required to include the books' value in income).

exactly replaces a racket valued at $400 there is no "accession to wealth;" plaintiff has not received anything more than she had. Her original acquisition of the racket was by a purchase with tax-paid dollars, so the recovery is not a substitute for ordinary income.

Now consider a plaintiff who is injured in an automobile accident and loses the use of his left leg. For simplicity, assume that the injury did not result in lost wages or loss of earning capacity. He accepts a settlement of $500,000. The return of basis analysis that made the previous example easy to resolve does not help this plaintiff. Yet, just as clearly, he has been "restored," if only by a monetary payment, to the status quo. He has not received anything more than he had. The taxpayer did not have a tax-paid basis in the leg,[34] so the question is whether the recovery substitutes for ordinary income or instead for some nonincludible value. It appears that the recovery is a substitute for the nonincludible value of being physically whole — the value of having the leg, the value of its use, and the value of being free from pain.

Nonincludible values can be divided into capital values and imputed income values. In the tennis racket example, it is easy to see that the plaintiff recovers $400 that represents the capital value of the tennis racket, and that ownership of a tennis racket (a consumer durable) produces untaxed imputed income (the annual rental value). The recovery of $400 is a tax-free return of basis; the imputed income from use of a replacement racket goes untaxed because Section 61 has traditionally been interpreted to exclude imputed income from the ownership of consumer durables.[35] Recovery for the lost limb can be divided along similar lines: the monetary "replacement" of the leg represents the replacement of the human capital value of being physically whole and the imputed income value flowing from physical wholeness. The difference between the two recoveries of capital could be that return of the capital value of

34. *See supra* text accompanying notes 24-29.

35. *See Blueprints*, *supra* note 19; KLEIN BITTKER, STONE, *supra* note 20; Marsh, *supra* note 18; *see also* McIntyre & Oldman, *supra* note 18. If the $400 were placed in a savings account rather than invested in a replacement racket, the annual interest income would be includible. This difference in the treatment of investment return is a flaw in the tax code's implementation of the accretion model, but is accepted as a more practical alternative than the inclusion of imputed income from use of consumer durables. *Id.*

the tennis racket is untaxed because it is a recovery of tax-paid basis, while the return of the capital value of the leg is untaxed because it is a recovery of a capital value, the ownership of which normally is not taxed. Thus, Section 61 could be seen not only to exclude returns of basis, but also to exclude replacements for the value of human capital. This construction of a personal injury damage recovery is consistent with the Haig-Simons definition, which describes income in terms of consumption and accumulation of market rights: "Personal income . . . has to do . . . with rights which command prices (or to which prices may be imputed).[36] Human capital has traditionally been excluded from economic measurement of income because it is a value not measured in market terms.[37]

In addition to the capital value that the $500,000 payment to the plaintiff may be thought to replace, plaintiff has also lost the annual imputed income from that capital value. Annual imputed income from use of the limb is derived from the capital value of being physically whole. Annual imputed income also arises from the human capital values of being pain-free, disability-free, and free of the anxiety and emotional distress associated with the loss of a limb. These forms of imputed income are received tax-free by uninjured taxpayers. Thus, Section 61 could be thought to exclude not only human capital values, but also the return on human capital unless it is transformed into monetary values by the performance of services for another. This construction of a recovery for imputed income from human capital is consistent with the economic concept of income; in a nonslave state, this form of income should be disregarded because there is no market measure of income from human capital aside from actual earnings, which do not occur until services are performed in exchange for market values.[38] Thus, income theory supports the idea that not only

36. H. SIMONS, *supra* note 10, at 49.

37. *See* N. KALDOR, *supra* note 6, at 58 n.3. Exclusion of at least a part of personal injury damage recoveries as a replacement of otherwise nontaxable human capital is suggested by Yorio, *supra* note 8, at 713-14. For a thoughtful discussion of the concept of human capital and its influence on taxation, see Stephan, *supra* note 24. For classical discussions of the role of labor in production, see A. MARSHALL, PRINCIPLES OF ECONOMICS 680-88 (8th ed. 1920); 2 J.S. MILL, PRINCIPLES OF POLITICAL ECONOMY 346-81 (5th ed. 1901); 1 A. SMITH, THE WEALTH OF NATIONS 5-18, 104-24 (J.E.T. Rogers ed. 1880).

38. Kaldor considered whether the economic concept of income includes imputed income from human capital "in a non-slave state," and concluded that this

should the monetary "replacement" of the lost capital values be received tax free, but also the monetary "replacement" of annual imputed income from human capital.

The notion that a recovery for a lost limb represents the return of human capital helps to sort out the tax treatment of damage recoveries. Monetary replacements of human capital values and imputed income from their use ought to receive the same treatment — exclusion — as imputed income ordinarily receives. It is merely descriptive to identify human capital as an excluded capital value; like economic definitions of income, the tax code does not attempt to include human capital values. It is merely descriptive to note that imputed income from the use of human capital, somewhat like imputed income from the use of consumer durables, is not included in Section 61 gross income. In the case of human capital, it does not matter whether the imputed income is the annual value of the use of a limb or the annual value of services a taxpayer performs for herself; both are excluded from income. Only when the value of human capital is transformed into monetary terms by the performance of services for another does Section 61 appear to find income.

Exclusion of a monetary recovery for lost human capital is easily accomplished through a statutory provision like Section 104(a)(2). To exclude the monetary replacement of annual imputed income, the tax system has two choices: (1) either exclude the interest income from investment of the cash payment for the lost capital values, or (2) exclude an additional cash payment for the annual imputed income (whether paid annually or in a lump sum equal to the present value of annual future payments). Compare the tennis racket example. If plaintiff receives $400 for the tennis racket, she can choose either to replace the racket or to invest the $400 in an interest-bearing account. If she replaces the racket, she will have

form of income should be disregarded because "there is in fact no *objective* measure of income derived from personal earning power other than actual earnings—with possibly some over-all allowance for the element of negative appreciation involved in the age factor." N. KALDOR, *supra* note 6, at 58 n.3 (emphasis in the original). Another reason to disregard imputed income from human capital until the performance of services for another produces actual earnings is that everyone has this form of income; because its inclusion likely would increase the income base proportionately to actual earnings, the rate structure of a tax system automatically adjusts for its exclusion. *See* authorities cited *infra* note 61.

nonincludible imputed income from ownership of a consumer durable. If she invests the money, she will have includible interest income. The plaintiff who receives cash for the lost capital value of the tennis racket can choose to replace the racket and enjoy the excludible annual value of its use. The plaintiff who receives cash for the lost capital value of the limb cannot replace the limb, and so cannot enjoy the excludible annual value of its use. To give the personally injured individual tax treatment comparable to the economically injured individual, the tax law should exclude the replacement of annual imputed income from lost human capital.

It is not only the absence of choice that compels exclusion, but a real difference in the two forms of imputed income. Failure to tax the imputed income from consumer durables is a flaw in the tax system's implementation of income theory. The annual rental value of the racket is an economic benefit in market terms that should be included because it falls within the personal consumption component of Haig-Simons definition. In contrast, failure to tax the imputed income from physical wholeness is not a flaw in the system; this sort of income would not fall within the accretion model because it is not an economic benefit in market terms.[39] Only in the event of personal injury does it become necessary to set a monetary value on what is lost. Failure of the tax system to include the annual imputed income from ownership of consumer durables makes it even more important that plaintiffs who have lost human capital values normally enjoyed tax-free remain nontaxable on their replacement and the replacement of the imputed income from those capital values.

D. *Measuring Nonincludible Values*

1. *Capital and Income*

The example of the tennis racket can serve as a model for the measure of human capital values. The racket's market value is $400 (the price a willing buyer would pay a willing seller). But like any capital item, for example a bond purchased for $400, the cost also represents the present value of expected returns from the item.[40] The accretion model

39. *Id.*

40. *See* N. KALDOR, *supra* note 6, at 58; Cunningham, *A Theoretical Analysis of the Tax Treatment of Future Costs*, 40 TAX L. REV. 577, 581 (1985); Halperin, *supra* note 22,

treats those returns as income as they accrue.[41] Thus, recovery for loss of the tennis racket requires the payment of $400 (a return of basis); restoring this amount to the plaintiff will also give her future income equal to the present value of either (1) the includible interest income from investment of the $400; or (2) the excludible imputed income from the use of a replacement racket. These income streams are equal in pre-tax present value. The present value of future interest income from investment of the $400 can be assumed to be $400;[42] thus the present value of the future imputed income from the replacement racket can also be assumed to be $400.

It is not necessary for the legal system to require the defendant to pay the plaintiff both the capital cost of the racket and the present value of the income stream from its ownership; the market (via the investment of the $400) or the personal use of a replacement racket (annual rental value) provides annual income from ownership of the tax-paid capital item. From an after-tax standpoint, the plaintiff is better off if the $400 is used to purchase a replacement racket. The plaintiff can choose to receive either a pre-tax return that is never subject to tax, or a return equal in pre-tax value that is includible in income. The income tax system permits this distortion.

Like the plaintiff who recovers for the tennis racket, the plaintiff who has lost his leg is entitled to recover both the money value of the lost capital items, and the money value of the lost income from the use of the capital. If it is assumed that the lost limb was worth exactly $500,000, then it can be assumed that the lifetime annual imputed income from use of the lost capital values has a present value of $500,000.[43] Absent the injury, the plaintiff would have retained (untaxed) the capital value of $500,000, and over his remaining life would have enjoyed (untaxed) annual imputed income with a present value of $500,000. If the object of the damage recovery is to restore him (via a monetary payment) to the pre-injury status, he ought to receive tax-free both the capital value and the annual imputed income from its use.

at 512-13. *See also* Boskin, *Notes on the Tax Treatment of Human Capital*, Conference on Tax Research 185, 187 (U.S. Treasury 1975).

41. *Id.*

42. *Id.*

43. *Id.*

There are three ways to achieve this result. One is to permit the plaintiff to receive tax-free the $500,000 capital value, and then exclude from income the interest earned on investment of that amount. Another is to exclude the initial and subsequent periodic payments from the defendant (or a third party insurance company).[44] A third equivalent would be to exclude both the $500,000 capital amount and an additional $500,000 payment that represented the present value of the future imputed income stream.

It thus becomes nearly irrelevant what yardstick is used to measure the extent of plaintiff's loss, so long as it is possible to identify an amount that is to "replace" the lost human capital values. That amount can be presumed to be the same as the present value of future annual imputed income from the capital values. Both the capital and income values should be excluded from plaintiff's income. The tax treatment of the damage recovery should not turn on the form in which the values are replaced, or on the particular criteria used to measure the loss.

2. *The Problem of "Lost Earnings"*

A replacement for nonincludible values may not be income, but what if part of a recovery is said to be for lost earnings? Is that part of the payment includible? A case can be made for inclusion. A payment for past lost wages is an accession to wealth that compensates the plaintiff for earnings he did not receive while away from his job during convalescence. If the earnings had been received, they would have been taxable as ordinary income. Thus, the past earnings portion of the settlement appears to be an includible substitute for ordinary income. The same analysis could apply to a payment for lost future earnings: the settlement does not replace something the plaintiff had, but instead confers something new upon him, so he has an accession to wealth; the future earnings would have been includible, so the substitute should be.

There is another way of thinking about this problem. If the

44. A structured settlement arrangement gives the plaintiff periodic payments excludible under I.R.C. § 104(a)(2). I.R.C. § 130 permits defendants or their insurance companies to assign a physical personal injury payment obligation to a third party, if the statutory conditions (primarily designed to safeguard plaintiffs' interests) are met.

"earnings" part of the settlement is conceived of as recompense for loss of earning *capacity*, then the monetary payment restores the taxpayer to his previous status as a person with income-earning potential. Economists have considered whether imputed income derived from the capitalized value of personal earning power should be included in the definition of income. In a nonslave state, personal earning power cannot be bought or sold and is not valued in market terms.[45] Because the imputed income flowing from earning capacity (as opposed to actual income from the exercise of that capacity) is not capable of objective measure, it is not generally included in the economic definition of income.[46] Human capital does exist as a value; it produces imputed income; but the imputed income is ignored in the measure of taxable capacity until "actual" income occurs from the performance of labor.[47] Other people are not taxed on either the capital value of having income-earning potential or the imputed income that flows from the capacity to earn; neither should the plaintiff in a personal injury case. The tax system really has not dealt with the problem of nonservices exchanges between human capital and market capital, but the fact that the *measure* of human capital loss may be expected future earnings should not alter the result.[48]

A response to this argument might be that most people are taxed indirectly on their earning capacity because they pay tax every year on the monetary income produced by the exercise of their earning capacity in the performance of services. The plaintiff in a personal injury suit could be said to exercise his "earning capacity" by winning a judgment against the defendant (although payment may be in a lump sum rather than in annual increments over the plaintiff's working life). Loss of

45. N. KALDOR, *supra* note 6, at 58.

46. *Id.* at 58 & n.3; *cf.* Boskin, *supra* note 40, at 192.

47. *See id.*

48. The Tax Court expressed this measuring idea well in Threlkeld v. Commissioner, 87 T.C. 1294, 1299 (1986), *aff'd*, 848 F.2d 81 (6th Cir. 1988). An example of an exchange at the margin between human capital and market capital is U.S. v. Davis, 370 U.S. 65 (1962), where Mr. Davis was taxed on the exchange of stock for his wife's marital rights. Mr. Davis acquired human capital via an expenditure of market capital, and so was entitled to claim a tax-paid basis in the human capital values. But what became of the asset Davis bought? Was his expenditure for personal consumption? Or did he invest in human capital that disappeared in the exchange? The tax system lacks the language to discuss nonservices exchanges between market capital and human capital.

earning capacity is measured by expected future earnings because this part of the judgment is intended to substitute for ordinary income. Under this analysis, the "lost earnings" portion of an award or settlement should be includible in the plaintiff's income.[49]

It does not seem a satisfactory answer to say that the plaintiff should be taxed on the recovery for lost earning capacity because the pursuit of his claim is the equivalent of the performance of services for another. Suppose it is possible to identify a part of the recovery as representing only the lost capital value of capacity to earn income. People normally enjoy this value tax-free, incurring tax only when the capacity is exercised by work. If an individual chooses not to work, and therefore not to transform the capacity into includible income, the unexercised capacity is not taxable. Put another way, the choice of leisure is not taxable. The capital value of earning capacity can be thought to produce both includible income from labor, and nonincludible imputed income from the choice of leisure.[50] The plaintiff who is injured so that part of his human capital is lost, and who sues for replacement, may be pursuing the only possible course to recover the nonincludible capital values that were damaged. It does not seem correct to equate the decision to sue with the choice of earning when a person with intact human capital has imputed income from all the human capital values, including earning capacity, and remains untaxed.[51]

49. In a "structured settlement," which is paid in annual amounts, the plaintiff obtains an income stream that, to the extent payments are allocable to the "earnings" part of the settlement, could be thought of as a substitute for income that would be produced by the exercise of earning capacity. *See* Stephan, *supra* note 24, at 1396-97. I.R.C. § 104(a)(2) expressly excludes a series of payments as well as a lump sum (which would be the present value of the future stream of payments). *See generally* McCormick Damages, § 86 at 304-07 (1935) (collecting cases).

50. It is difficult, however, to separate the replacement of future earnings from replacement of lost future leisure and other nonincludible income, which may justify either a complete exclusion or a proportionate exclusion of periodic payments to an injured plaintiff. *See* Stephan, *supra* note 24, at 1397.

51. The question may arise whether the estimate of lost future wages (or other estimates of future amounts) should take into account expected inflation in wages. If the payment to plaintiff is in a lump sum, the anticipated stream of future income or expense should be reduced to present value. If expected inflationary increases in wages or cost of goods and services are taken into account, the future stream should be valued at a discount rate equal to the nominal interest rate, because the nominal rate is thought to include an inflation factor. If a current wage scale (or current cost) is used, so that inflation is not taken into account, the discount rate should be the real rather than the nominal rate of interest — roughly, the nominal rate minus the infla-

It might be said that the plaintiff's decision to argue lost future earnings is a choice to seek an income substitute, and the plaintiff who does not present evidence of lost future earnings has chosen the nontaxable substitute for leisure. The problem with this analysis is that a recovery for personal injury replaces with money many human capital values and their annual imputed income. The plaintiff should be able to seek a monetary replacement of human capital and imputed income from lost human capital without the tax consequences depending on whether anticipated future income is discussed. The monetary income that would have been produced by the exercise of the capacity through employment may be the only possible objective measure of the plaintiff's loss. Use of earnings as a measure of loss (rather like capitalization of a future income stream to arrive at the current capital value) should not be confused with correct identification of the lost asset.

It is possible to argue that excluded capital and income values ought to be includible when the damage recovery transforms them into monetary terms. The argument is similar to the suggestion that pursuing the claim is equivalent to exercise of personal earning power, but is based on the idea that imputed income is excluded only because it is hard to measure. Once the income is reduced to monetary values, it ought to be included. This convenience notion of income measurement has some place in the tax law; the realization requirement operates to cause income inclusion only when accretions to in-

---

tion component. If the estimate includes inflation, the future stream will be a greater amount than if anticipated inflation is not taken into account, but the discount rate will be the higher nominal interest rate. If current income figures are used, the estimated future stream will be a lesser amount discounted at the lower real interest rate. The lump sum should be the same.

One way to arrive at the real interest rate is to subtract the expected inflation rate from the nominal interest rate, using the U.S. Department of Labor's Consumer Price Index (CPI) and past CPI increases to estimate future inflation. The 1986 Minnesota Tort Reform Act, which required that jury judgments of future losses be restated at present value, prohibited "reference to projected inflationary or noninflationary changes." MINN. STAT. § 604.07 (1986), *repealed*, Act of April 12, 1988, ch. 503, §§ 5, 6, 1988 Minn. Laws 375, 378. The statutory discount rate was the average nominal interest rate for the five years preceding the date of judgment reduced by an inflation factor based on the average CPI increase over the same period. *Id.* Repeal of Minnesota's discount statute left in place the law in effect before the statute was enacted in 1985, under which the jury is instructed that amounts awarded for loss of future earnings and medical expenses must be discounted to present value. *See* Olsen v. Special School District #1, 427 N.W.2d 707 (Minn. Ct. App. 1988); Steinhaus v. Adamson, 304 Minn. 14, 21, 228 N.W.2d 865, 869 (1975).

come are rendered fairly certain by the happening of a some event, like a sale or exchange, that clearly identifies an accession to wealth. In the example of the tennis racket, income from the $400 is taxable if it is received as interest on investment of the funds, but excludible if received as imputed income from the use of a consumer durable. It is difficult to measure imputed income from the tennis racket, so it is excluded; the parallel income, interest from the investment, is easy to measure and so is included. Thus, the argument goes, the tax system should include cash recoveries for personal injuries on the theory that cash is includible no matter what its origin.[52]

It is a flaw in the tax system's implementation of the accretion model that easily measured accretions to wealth are included and more difficult to measure values are excluded.[53] An ideal accretion-type tax may be impractical;[54] as long as accretion is the model, adjustments for practical problems of measurement are only to be expected. But the need to adapt the accretion model to everyday use does not compel inclusion of amounts simply because they are there. Returns of basis, for example, may be paid in cash but are not for that reason subject to inclusion. Substantial cash gifts to family members are not includible even though they are easy to measure. Cash payments of child support are not includible. Reference to income theory suggests reasons why these easy-to-reach transfers are excludible;[55] convenience is not the sole arbiter of the tax base.

Exclusion of the imputed annual income from human capital until it has been translated into monetary terms by the performance of services for another provides a consistent basis for the measure of income. In a very real sense, all economic

52. *See* Cochran, *supra* note 8, at 48-49; Frolik, *supra* note 8, at 40.

53. *See* Andrews, *supra* note 6; *Blueprints*, *supra* note 19; *See also* Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. PENN. L. REV. 1111 (1986).

54. *See* Andrews, *supra* note 6.

55. Under I.R.C. § 1001, returns of tax-paid basis are excluded so that the tax is imposed on net income (consistent with the net change in worth component of the Haig-Simons definition of income); under I.R.C. § 102, gifts are excluded from income, producing a result at least roughly equivalent to treatment of transfers within the family, a single taxable unit, as one incidence of personal consumption; under I.R.C. § 71(c), child support payments are excludible from the recipient's income, treating transfers to support children as a single incidence of consumption by the payor.

power is produced by the exercise of personal earning capacity through labor compensated in the marketplace because capital values normally measured in monetary terms derive originally from the labor of an individual. From gold to corporate stock to certificates of deposit, capital goods are available in market terms only through the exercise of human potential. The monetary income that flows from market capital values, like the monetary income produced directly from the performance of services, has its origin in human labor. Despite the significance and value of personal earning capacity, it is not included in economic definitions of income until transformed by labor into market terms.

The plaintiff who recovers a personal injury damage award has not received a windfall that ought to be taxed. Nor is the transformation of human capital into money via the judgment a substitute for the performance of services. The injured plaintiff has lost a value that cannot be replaced like a tennis racket, because it is not a value that the economy measures in market terms. Failure to include imputed income from consumer durables is a flaw in the measurement of income that results from practical considerations, but the imputed income from human capital is outside the measurement of income. The plaintiff who recovers for lost human capital and lost imputed income from human capital is recompensed for values that lie without the market. Use of money to replace what is lost does not justify imposing tax on a person who has merely been restored (if that) to a status other taxpayers enjoy tax-free.

3. *Relationship of State Law*

In the decided cases and IRS revenue rulings, it is not clear whether under state law the "earnings" portion of damage awards is intended to represent loss of imputed income from earning capacity, an excludible value, or instead a substitute for actual earnings, an includible value. It could be said that state law intends the "earnings" portion to include both a substitute for actual earnings (past and future) the plaintiff likely lost because of the injury, and an amount that compensates the plaintiff for loss of nonincludible values like personal earning power and the potential to enter a range of occupations (a particularly important aspect of damages in cases involving children or young adults). Most states, for example, allow juries to consider the plaintiff's loss of occupational choice as an element of damages: "The law recognizes the possibilities open to ambition."[56] State jury instructions on "loss of earning capacity" seem to contemplate that this element of damages is broader than mere loss of future wages. For example, the comment to the Minnesota instruction on loss of earning capacity states unequivocally that the measure of future damages "is loss of earning *capacity*, not loss of earnings," and past "lost earnings" may be awarded even if plaintiff was unemployed at the time of the injury.[57] In a few states, however, instructions expressly limit loss of "earning capacity" to the past and future lost earnings, not lost capacity attributable to the injury,[58] perhaps suggesting an intention to eliminate the loss of an imputed value from the jury's consideration. On the whole, however, state law appears to embrace the concept of human capital and loss of imputed income from damage to plaintiff's person.

Although state law could be read to support an allocation of a predominant part of personal injury recoveries to nonincludible values, and some part to includible income substitutes, reliance on state law to sort out includible from excludible values would be misplaced. Jury instruction guidelines in personal injury cases are aimed at helping the jury to a reasonable valuation of the plaintiff's loss and creating some consistency in valuations within the state.[59] In reaching a special verdict, juries may be asked to determine specific monetary amounts in separate categories, including loss of earnings; medical expenses; embarrassment and emotional distress; and

56. *See, e.g.*, McCormick, *supra* note 49, at 300 (collecting cases).

57. Minnesota Jury Instruction Guide, JIG 157 at 146, *citing* Blacktin v. McCarthy, 231 Minn. 303, 42 N.W.2d 818 (Minn. 1950), JIG 160 at 149 (emphasis added), citing Riley v. Luedloff, 253 Minn. 447, 92 N.W.2d 806 (Minn. 1958), and Wilson v. Sorge, 256 Minn. 125, 97 N.W.2d 477 (Minn. 1959) (West 1986). *See* Arkansas Model Jury Instructions, Civil, AMI 2206 at 293 (loss of future earnings), AMI 2207 (loss of earning capacity) (West 1974).

58. *See* Wisconsin Jury Instructions, Vol. II (Civil), JI 175OA, subd. 4 (1982) (amount to be awarded for impairment of earning capacity is "the difference between what the plaintiff will reasonably be able to earn in the future in view of his injuries, and what he would have been able to earn had he not been injured").

59. *See generally* Minnesota Jury Instruction Guide, JIG 151 through 164 at 131-58 (West 1986); Illinois Pattern Jury Instructions, Civil, IPI2d 30.01 - .09 at 140-49 (West 1971); Arkansas Model Jury Instructions, Civil, AMI 2201 through 2209 (West 1974).

pain, disability, and disfigurement.[60] These state law classifications are intended to focus the jury's attention on objective measures of loss, not to allocate the recovery between excludible and includible parts. Perhaps the categories included in jury guidelines are consistent with an attempt to measure the loss from damage to human capital because that is what a personal injury cases are about.

The economic literature suggests that actual earnings from the performance of services are the only "objective measure" of the imputed income from personal earning power.[61] The states' use of expected future earnings as a measure of plaintiff's loss is not only appropriate but probably essential to an accurate valuation of the human capital loss. Use of a future income stream is clearly relevant in valuation of a capital item that produces income,[62] and the states' valuation methods can be presumed to reach a reasonably accurate (or at least not excessive) determination. Discounting the lost future income to present value, as most states do,[63] achieves reasonable accuracy in time value of money terms. Exclusion of the entire recovery as a loss of human capital and imputed income from human capital is consistent with income theory.

Courts deciding federal tax cases have accepted state law valuations of loss, and have excluded the entire amount, even

60. *See, e.g.*, MINNESOTA JURY INSTRUCTION GUIDE, JIG 151 through 164 at 131-58 (West 1986); ILLINOIS PATTERN JURY INSTRUCTIONS, CIVIL, IPI2d 30.01 - 09 at 140-49 (West 1971); ARKANSAS MODEL JURY INSTRUCTIONS, CIVIL, AMI 2201 through 2209 (West 1974).

61. *See* N. KALDOR, *supra* note 6, at 58 n.3; Miller, *Can the Public's Desire for Future Benefits Be Deduced from Their Private Decisions*? 43 AM. J. OF ECON. & SOC'Y 443, 448 (1984) ("Human capital is nonmarketable and nonliquid. . . . The difference in marketability between human and most physical capital casts doubt on the desirability of treating the two forms of investment as equivalent in economic theory"); *cf.* Boskin, *supra* note 40, at 192; Sgontz & Pogue, *Non-Monetary Returns to Human Capital: Implications for Inter-Temporal Tax Neutrality*, 39 National Tax J. 201, 206-07 (1986); Hartog, *An Ordered Response Model for Allocation and Earnings*, 41 KYKLOS 113 (1988); Flug & Galor, *Minimum Wage in a General Equilibrium Model of International Trade and Human Capital*, 27 INT'L ECON. REV. 149 (1986).

62. *See* Internat'l Assoc. of Assessing Officers, IMPROVING REAL PROPERTY ASSESSMENT 254-59, 288-96, 298, 300-02 (1978).

63. *See, e.g.*, Olsen v. Special School District #1, 427 N.W.2d 707 (Minn. Ct. App. 1988); Steinhaus v. Adamson, 304 Minn. 14, 21, 228 N.W.2d 865, 869 (1975); *see also* authorities cited *supra* note 60. The structured settlement of a personal injury case also appears to reach a result that is reasonably accurate in time value of money terms, because annual payments mimic the annual receipt of imputed income from capital values. Periodic payments for personal injury are specifically excluded from income. I.R.C. § 104(a)(2).

though lost earnings are considered.[64] The courts also have relied on state law to define "personal injury" for purposes of Section 104(a)(2).[65] The Treasury regulations, which define "personal injury" damages as amounts received from "tort or tort-type" claims,[66] encourage this result. As a rough guide to separate excludible recoveries for loss of human capital values from includible income substitutes, reference to common law notions of tort-like harm is well-conceived: there is a class of torts based on the idea of unacceptable invasions of the human person. But state law classification of a claim as lying in tort should not determine the tax consequences; the rule is too broad, and is likely to result in horizontal inequity.

The reason a rule excluding all tort damage recoveries is too broad is that many tort claims do not arise from injury to human capital or other excludible values. An easy example is a tort claim arising from damage to property.[67] As with conversion of the tennis racket, a property damage claim may entitle the plaintiff to a tax-free return of basis, but clearly the recovery is for loss of a market value. The statute's reference to "personal injury" should be effective to keep this class of tort claim outside the Section 104(a)(2) exclusion and within the normal rules of gain computation. Some tort claims, however, may be less clear. Misrepresentation, for example, may give rise to a tort action, but the possible wrongs range from bodily harm (feeding plaintiff poisoned chocolates) to emotional distress (telling plaintiff as a "joke" that her husband had broken both legs) to monetary loss (selling plaintiff a $500 share in land that did not exist).[68] The tort of deceit may involve deception of an individual, but the injury usually is a market loss,

64. Roemer v. Commissioner, 716 F.2d 693, 699 (9th Cir. 1983), *rev'g*, 79 T.C. 398 (1982); Threlkeld v. Commissioner, 87 T.C. 1294, 1299 (1986).

65. *See* Threlkeld v. Commissioner, 87 T.C. 1294, 1305, 1306 & n.6 (1986), *aff'd*, 848 F.2d 81 (6th Cir. 1988); Glynn v. Commissioner, 76 T.C. 116, 119 (1981), *aff'd. without published opinion*, 676 F.2d 682 (1st Cir. 1982) ("essential element of an exclusion under section 104(a)(2) is that the income involved must derive from some sort of tort claim against the payor").

66. Treas. Reg. § 1.104-1(c).

67. *See, e.g.*, RESTATEMENT (SECOND) OF TORTS § 226 (1977).

68. See W. KEETON, D. DOBBS, R. KEETON & D. OWEN, PROSSER AND KEETON ON THE LAW OF TORTS § 105 at 725-27 & nn.1, 5-6 (5th ed. 1984), *citing* Commonwealth v. Stratton, 114 Mass. 303 (1873) (chocolates); Wilkinson v. Downton, [1897] 2 Q.B. 57, 77 L.J.Q.B. 493 (joke); Holland v. Bishop, 60 Minn. 23, 61 N.W. 681 (1895) (nonexistent land).

not a loss of human capital value.[69] In a similar vein, tortious interference with contractual relations[70] may involve a wrong done to a human being, but the injury is a loss of money value. The statutory phrase "personal injury" should be interpreted to guard against the automatic exclusion of recoveries for monetary loss. The concept of human capital as a nonincludible value can serve to distinguish between recoveries for market losses and recoveries for nonmarket "personal injuries."

There also is a risk that reliance on state law determinations of whether a claim is a "tort" will cause inconsistent treatment of taxpayers who recover damages for loss of human capital. For example, in *Roemer v. Commissioner*,[71] the Ninth Circuit examined California law to determine whether a claim of defamation was a tort and therefore a "personal injury." California had codified many common law claims, and it had divided the common law tort into several different actions. The court concluded that the claim plaintiff had pursued was a tort, and the damage recovery excludible.[72] Careful reading of the court's opinion reveals a sensitivity to the loss of human capital, and the use of income loss as merely a measure of harm. "The personal nature of an injury should not be defined by its effect," the court observed, referring to the "effect" of lost business income from defamation of the plaintiff.[73]

The *Roemer* holding, however, has emerged simplified as the view that state law characterization of a personal injury claim as "tort" determines the excludibility of damages.[74] Rigid adherence to this rule would promote inconsistent treatment of recoveries for damage to human capital. A particular state's attempt to order and clarify its common law should not govern federal tax consequences. The essential determination is whether the recovery is for the loss of human capital and its

69. KEETON & DOBBS, *supra* note 68, § 105 at 726-27.

70. *Id.* § 129 at 978-79 & nn. 1-2. *See, e.g.*, Texaco, Inc. v. Pennzoil Co., 729 S.W. 2d 768 (Tex. App. 1987), *cert. dismissed*, 108 S.Ct. 1305 (1988).

71. 716 F.2d 693 (9th Cir. 1983), *rev'g*, 79 T.C. 398 (1982).

72. *Id.*

73. *Id.* at 699.

74. *See* Threlkeld v. Commissioner, 87 T.C. 1294, 1306 & n.6 (1986), *aff'd*, 848 F.2d 81 (6th Cir. 1988), *citing*, Glynn v. Commissioner, 76 T.C. 116, 119 (1981), *aff'd. without published opinion*, 676 F.2d 692 (1st Cir. 1982) ("essential element of an exclusion under section 104(a)(2) is that the income involved must derive from some sort of tort claim against the payor").

imputed income values, which are excluded because they are not normally measured in market terms. Courts deciding tax cases are equipped to determine whether a claim is for damage to values that other taxpayers enjoy tax-free; horizontal equity in the treatment of taxpayers requires that the determination be a federal one.

E. Punitive Damages

In contrast to recoveries for loss of human capital, punitive damages do not compensate the plaintiff. Instead, they penalize the defendant for wrongful conduct. A damage award should be includible if it replaces something taxable that the taxpayer had and lost before it could be taxed, or if it substitutes for ordinary income not previously received. Punitive damages do not replace something the taxpayer had and lost; they arise from the lawsuit and are intended to punish the defendant for wrongful conduct. Should they be taxable to the plaintiff as a substitute for ordinary income?

One answer is that punitive damages do not substitute for income the taxpayer would have earned in the ordinary course, so they should not be regarded as ordinary income. But the 1955 decision in *Commissioner v. Glenshaw Glass Co.*[75] established that "windfall" income (in that case, punitive damages from antitrust violations and contract fraud) is includible as Section 61 ordinary income. A punitive damage award in any cause of action should be thought of as a windfall to the taxpayer because it is neither an expected accrual nor compensation for a loss. In income theory, windfalls are the ideal subject of taxation.[76] The recipient of a punitive award is the beneficiary of a court-imposed penalty for the defendant's bad acts. The *Glenshaw* definition of income, as "accessions to wealth, clearly realized, and over which the taxpayers [had] dominion"[77] also compels inclusion of punitive damages, and suggests no distinction between punitive damage awards because of the cause of action from which they arose.

For many years, however, the practice of the Internal Revenue Service was to exclude punitive damages in personal injury

75. 348 U.S. 426 (1955).

76. *See* N. KALDOR, *supra* note 6, at 68-69.

77. Glenshaw Glass, 348 U.S. at 431.

cases.[78] The Service's rationale was that Section 104(a)(2) excludes "any damages" for personal injury. The Service's more recent position is that all punitive damages are includible, because Section 104(a)(2) excludes only damages received "on account of" personal injury.[79] Punitive damages, which the Service now regards as received "on account of" the tortfeasor's wrongdoing, are not excludible under Section 104(a)(2).[80] Neither position is said to be based on income theory, but the more recent ruling, which cites *Glenshaw Glass*, is justified under the accretion model. A punitive damage award confers an economic benefit on the plaintiff. The payment does not represent recovery of a nonincludible value, and can be regarded as a windfall that is ordinary income under the *Glenshaw* test. Income theory supports the taxation of punitive damage awards.

F. Deductibility by the Payor

Payment of damage awards should be deductible on the same terms as other payments: if the payment can be construed as an "ordinary and necessary" business expense, then it should be deductible like any other Section 162 business expense. This approach has generally been accepted by the IRS and the courts. If the events that gave rise to the lawsuit were activities in the ordinary course of the defendant's business, and the amount is current rather than capital, then the damage award is considered a Section 162 expense.[81]

---

78. *See* Rev. Rul. 75-45, 1975-1 C.B. 47.

79. Rev. Rul. 84-108, 1984-2 C.B. 32.

80. *Id.*

81. *See, e.g.*, Mulgrew Blacktop, Inc. v. U.S., 311 F. Supp. 570 (S.D. Iowa 1969); Vanderbilt v. Commissioner, T.C.M. 1957-235; *see also* Potts, *Income Tax Issues in Personal Injury Litigation*, 46 MONT. L. REV. 59, 63-65 (1985) (summarizing authorities).

Timing of the deduction should be consistent with the payor's ordinary method of accounting. Because of the I.R.C. § 461(h)(2)(C) "economic performance" requirement, added in 1984, both accrual and cash basis defendants are able to deduct the amount of a damage award only in the year in which payments are made to the plaintiff. I.R.C. § 461(h)(2)(c) provides: "If the liability of the taxpayer requires a payment to another person and (i) arises under any workers compensation act, or (ii) arises out of any tort, economic performance occurs as the payments to suchperson are made." If the defendant pays a third party to assume the payment obligation of a structured settlement, as permitted under I.R.C. § 130 (for damages arising from physical injury), the defendant ought to be allowed to deduct currently its payment to the third party; the statutory language, however, is ambiguous. *See* May, letter to R. Pearlman, 25 TAX NOTES 69 (1984). A transitional rule added by the 1986 Tax Reform Act allowed the defendant in an asbestos tort case to deduct an indemnification

Although this analysis is appropriate for the compensatory part of a judgment or settlement, public policy considerations should preclude deduction of a punitive damage award. For public policy reasons, fines and penalties paid for violations of the law have long been held nondeductible under Section 162.[82] But payments of punitive damage awards have been treated as deductible expenses. Revenue Ruling 80-211, for example, states that punitive damages arising from the ordinary conduct of a business are deductible.[83] The tax code is mostly silent on the point; Congress has enacted rather narrow provisions. Section 162(c), for example, expressly makes illegal bribes and kickbacks nondeductible; Section 162(f) makes fines and penalties nondeductible; and Section 162(g) makes the punitive two-thirds of criminal antitrust judgments nondeductible.[84]

As a matter of tax theory, the payment of an award does reduce income available to pay tax. If the events giving rise to the lawsuit arose in the ordinary course of business, then the punitive damage element might properly be considered a cost of producing income, and therefore deductible.[85] The income tax is imposed on net income, not gross income, so even the expenses of operating an illegal business are deductible.[86] On

payment to an insurance company, and added new I.R.C. § 468B, which allows payments made to a court ordered settlement fund that extinguishes the taxpayer's liability to be considered economic performance, thus permitting a current tax deduction. Pub. L. No. 99-514, § 1807(a)(8).

If the defendant is insured, the insurance premiums are deductible as a Section 162 expense, and the insurance company is allowed a deduction for its payments.

82. Tank Truck Rentals v. Commissioner, 356 U.S. 30 (1958); United Draperies v. Commissioner, 340 F.2d 936 (7th Cir. 1964). The policy of nondeductibility of fines has been incorporated in I.R.C. § 162(f).

83. Rev. Rul. 80-211, 1980-2 C.B. 57; *see* Treas. Reg. § 1.162-1(a). Under some circumstances, the amount of the award may be viewed as a capital expenditure under Section 263 rather than a currently deductible business expense under Section 162. *See* Anchor Coupling Co. v. U.S., 427 F.2d 429 (7th Cir. 1970), *cert. denied*, 401 U.S. 908 (1971).

84. The implication of the statutory prohibition is that the punitive two-thirds of a *civil* antitrust award is deductible. I.R.C. § 162(c) was enacted in 1958 by Pub. L. No. 85-866; §§ 162(f) and 162(g) in 1969 by Pub. L. No. 91-172.

85. *Cf.* Commissioner v. Tellier, 383 U.S. 687 (1966); Commissioner v. Sullivan, 356 U.S. 27 (1958).

86. *See* Commissioner v. Sullivan, 356 U.S. 27 (1958) (deduction allowed for rental costs of gambler's illegal gambling headquarters). In Commissioner v. Tellier, 383 U.S. 687 (1966), the Court allowed a securities dealer convicted of criminal securities fraud to deduct the costs incurred in his unsuccessful defense. The Court ruled that the costs were deductible under Section 162 because the origin of the

the other hand, it could be argued that conduct giving rise to punitive damages should not be viewed as sufficiently connected with a business to permit deduction of the payments as costs of producing income.

The "ordinary and necessary" test of Section 162 is properly viewed as codification of a rule allowing deduction of current costs in furtherance of a business.[87] The phrase allows deduction of expenses if the cost is "ordinary," which has been interpreted as the "common and accepted" means of responding to a business exigency, and "necessary," which has been read to mean "appropriate and helpful."[88] As the test has developed in the courts, "ordinary" might appear to approve any costs arising from an expedient business decision, however deserving it may be of punitive damages, but the "necessary" part of the test, with its consideration of appropriateness, has been held to include a public policy element.[89] Courts have not refused deductions on public policy grounds, however, except where the expense was a fine or penalty.[90] In the case of punitive damages, part of the reason for this judicial restraint is historical: the IRS has considered the punitive portion of an award deductible,[91] and taxpayers have not urged elimination of the privilege.

Tax theory requires deduction of the costs of producing in-

---

expense was the taxpayer's business. *Tellier* is perhaps best understood as a case where the Sixth Amendment established a public policy that favored deductibility of a criminal defendant's counsel fees in defense of charges based on business conduct.

87. The "principal function" of the term ordinary, assuming a connection to the taxpayer's business, is to distinguish between capital expenditures and currently deductible expenses. *Tellier*, 383 U.S. at 689. *See* Wolfman, *Professors and the "Ordinary and Necessary" Business Expense*, 112 U. PA. L. REV. 1089, 1111-14 (1964); Griswold, *An Argument Against the Doctrine that Deductions Should be Narrowly Construed as a Matter of Legislative Grace*, 56 HARV. L. REV. 1142, 1145 (1943).

88. Welch v. Helvering, 290 U.S. 111, 113-14 (1933). The *Welch* Court said that, to be "ordinary," payments need not be "habitual or normal in the sense that the same taxpayer will have to make them often. A lawsuit affecting the safety of a business may happen once in a lifetime. . . . Nonetheless, the expense is an ordinary one because we know from experience that payments for such a purpose, whether the amount is large or small, are the common means of defense against attack." *Id.* In *Welch*, the court "assume[d] the payments . . . were necessary for the development of the petitioner's business, at least in the sense that they were appropriate and helpful . . . and we should be slow to override his judgment." *Id.* (citations omitted).

89. Tank Truck Rentals v. Commissioner, 356 U.S. 30, 33 (1958). *See* Griswold, *supra* note 87, at 1145 & n.18.

90. *Id.* at 34; *see, e.g., Tellier*, 383 U.S. 687; Commissioner v. Sullivan, 356 U.S. 27 (1958). *But cf.* Mazzei v. Commissioner, 61 T.C. 497 (1974).

91. Rev. Rul. 80-211, 1980-2 C.B. 57.

come, even if the expenses are illegal or the business itself is illegal. The Section 162 "ordinary and necessary business expense" deduction has served as a rough and ready measure of income production costs. But even where expenses are undeniably a business expense, the "appropriateness" part of the Section 162 standard has been used to invoke public policy considerations if allowance of a deduction would "frustrate sharply defined national or state policies proscribing particular types of conduct."[92] This sort of legal schizophrenia probably represents a balancing of the need for accurate income measurement against a strongly-felt social policy goal. Does the social policy goal apply to punitive damages? A state jury's punitive damages award, particularly where statutes restrict the circumstances in which plaintiffs may assert a punitive damages claim,[93] would appear to be a rather "sharply defined" determination that the conduct of the defendant was outrageous and intolerable, whatever business exigencies may have been present. For example, Ford Motor Company's decision to proceed with unmodified production of the Pinto, even though tests showed that the gas tank was defective and would cause an explosion in a known percentage of rear end collisions, was viewed as an appropriate occasion for the award of punitive damages.[94] Deductibility allowed the federal government (and thereby all taxpayers) to share with Ford the burden of the state-imposed sanction.

State law standards for punitive damage awards typically require, as a minimum, "reckless disregard for public safety;"[95] "culpable indifference" to an "unnecessary risk of injury," including a "deliberate act or omission;"[96] or "flagrant indifference" to public safety.[97] It has been suggested that punitive

92. Commissioner v. Heininger, 320 U.S. 467, 473 (1943).

93. *See, e.g.*, MINN. STAT. § 549.20 (1986) (requires proof of clear and convincing evidence; willful indifference to the rights and safety of others).

94. Grimshaw v. Ford Motor Co., 119 Cal. App. 3d 757, 813, 174 Cal. Rptr. 348, 384 (Cal. Ct. App. 1981) (state statute required "malice" for punitive damages; court defined "malice" as conduct "done in conscious disregard of the probability of injury to the consuming public").

95. *See, e.g.*, Thiry v. Armstrong World Industries, 661 P.2d 515, 518 (Okl. 1983). *See also* MODEL UNIF. PRODUCT LIABILITY ACT, § 102(J) (reckless disregard is "conscious indifference to the safety of persons or entities that might be harmed by a product").

96. *See, e.g.*, Fischer v. Johns-Manville Corp., 103 N.J. 643, 512 A.2d 466 (N.J. 1986).

97. *See, e.g.*, Moore v. Remington Arms Co., 100 Ill. App. 3d 1102, 1115, 427

damages are necessary to impose a sufficient economic deterrent against socially costly conduct that may have cut costs for the defendant.[98] The states approving punitive damage awards may not have expressly adopted an economic analysis of law, but it is at a minimum reasonable for them to conclude that punitive damages provide "a surer deterrent than compensatory damages to conduct that we know we want to deter."[99]

When the courts assert public policy considerations to deny the deductibility of expenses justified by business expediency, the "test of nondeductibility always is the severity and immediacy of the [policy] frustration resulting from allowance of the deduction."[100] Fines are nondeductible because they are an economic sanction intended to deter unwanted conduct; permitting the wrongdoer to shift part of the economic burden to the federal government would frustrate, severely and immediately, the state policy expressed by imposition of the fine.[101] The states' imposition of punitive damage awards, an economic sanction to deter conduct in reckless disregard of public safety, deserves the same protection from frustration. The concept of a "net" income tax is not so rigid that it should prevent the Service and the courts from considering some "costs" of producing income too socially costly.

N.E.2d 608, 617 (Ill. App. 1981). *See generally* Note, *Extending Punitive Damages and The Consumer Expectation Test in Products Liability*, 11 CAP. U. L. REV. 363 (1981); Owen, *Problems in Assessing Punitive Damages Against Manufacturers of Defective Products*, 49 U. CHI. L. REV. 1 (1982); Owen, *Punitive Damages in Products Liability Litigation*, 74 MICH. L. REV. 1257, 1366-71 (1976) (suggesting the "flagrant disregard" standard).

98. LANDES AND POSNER, THE ECONOMIC STRUCTURE OF TORT LAW 160-63 (Harv. Univ. Press 1987). The authors offer an example: "if A's actual damages are $100 but people who commit these torts are identified and successfully sued only half the time, then, assuming risk neutrality and ignoring detection and legal costs, the injurer who is found liable should be made to pay A $200." *Id.* at 160 n.12.

99. *Id.* at 162 (referring to "reckless" conduct, where the "gap between the expected accident costs and the costs of avoidance is so great that there is little danger of penalizing socially beneficial conduct or inducing excessive care" by the award of punitive damages). *Accord* SHAVELL, ECONOMIC ANALYSIS OFACCIDENT LAW 147 (Harv. Univ. Press 1987) ("It follows that for injurers to be induced to behave optimally, the magnitude of liability should equal the sum of losses caused and of illicit utility gained. This will mean that, net of their liability payments, the only utility injurers will be able to obtain from the losses is socially valid utility. Consequently injurers will be led to make socially appropriate calculations").

100. Tank Truck Rentals v. Commissioner, 356 U.S. 30, 35 (1958).

101. *Id.*

II. Practice: Compensatory Damages for Personal Injury

Section 104(a)(2) expressly excludes from gross income the amount of "any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injury or sickness." The Treasury's regulations define the excludable "damages" as amounts received through prosecution of a suit for "tort or tort-type rights."[102] The rule of excludability applies to amounts paid as settlements as well as to court awards, and the plaintiff need not file suit for a settlement payment to qualify for the exclusion.[103] As long as a claim is for "personal injury," compensatory damages have been held excludable even though they are allocated in part to lost earnings.[104]

The Internal Revenue Service and the courts have had difficulty with two aspects of the definition of excludable damages. First is the regulation's use of the phrase "tort or tort-type" claims to identify excludible recoveries. The clear trend in the law is to treat as excludible the compensatory damages arising from common law tort claims as defined by state law. Statutory and constitutional claims have also been held "tort-like" and damages excluded,[105] but without articulation of a unifying theory. The second, and related, area of difficulty is the treatment of amounts received through claims involving evidence of a loss of income or business profits. Although it has long been the rule that the "earnings" component of an award for *physical* personal injury is excludable, in cases involving *non-physical* harm the definition of Section 104 "personal injury" has sometimes turned on whether the injury is "personal" rather than "business." For example, defamation cases are grounded in common law tort, but the Service and the Tax Court have denied exclusion where the injury was to the plaintiff's business persona.[106] The theory that human capital and

102. Treas. Reg. § 1.104-1(c).

103. *See, e.g.*, Rev. Rul. 85-97, 1985-2 C.B. 50.

104. *See id.*

105. *See* Bent v. Commissioner, 87 T.C. 236 (1986), *aff'd*, 835 F.2d 67 (3d Cir. 1987).

106. *See* Roemer v. Commissioner, 79 T.C. 398 (1982), *rev'd*, 716 F.2d 693 (9th Cir. 1983); Rev. Rul. 85-143, 1985-2 C.B. 55 (adopting the Tax Court's position in *Roemer* that business losses,restored through a defamation action, are not excludable under Section 104).

the imputed income it produces are outside the economic definition of income offers insight on the court decisions and suggests a coherent framework for decision-making.

A. *Physical and Nonphysical "Personal Injury"*

There is no question that the classic auto accident lawsuit is correctly viewed as a claim for "personal injury" damages excludable under Section 104. The regulations under Section 104 make "tort and tort-type" damages excludable,[107] and in Revenue Ruling 85-97 the Service reaffirmed its longstanding position that all damages arising from tort claims for physical personal harm are excludable.[108] The Tax Court most recently re-examined and reiterated this view in *Threlkeld v. Commissioner.*[109]

But not all personal harm is physical. Many claims that may be asserted do not arise out of common law tort and may involve nonphysical injuries. In *Bent v. Commissioner,*[110] the Tax Court decided that constitutional claims of free speech, advanced in an action against state officials under Section 1983 of U.S. Code Title 42, were sufficiently like common law tort claims to be "personal" injury within the Section 104 exclusion. Actions under federal statutes granting substantive legal rights to sue for bodily injury — for example, the Federal Employers Liability Act — have also been held sufficiently "tortlike" to fall within the exclusion.[111] Actions under federal statues that waive sovereign immunity but rely on state tort law to define the requirements for a successful suit — for example, the Federal Tort Claims Act — also have been held to give rise to excludable awards.[112]

It is well established that all compensatory components of an award are excludable if paid on account of physical personal

107. Treas. Reg. § 1.104-1(c).

108. Rev. Rul. 85-97, 1985-2 C.B. 50. *See* Rev. Rul. 85-143, 1985-2 C.B. 55, 56 (interpreting Rev. Rul. 85-97).

109. 87 T.C. 1294 (1986), *aff'd,* 848 F.2d 81 (6th Cir. 1988).

110. 87 T.C. 236 (1986), *aff'd,* 835 F.2d 67 (3d Cir. 1987). *See* Metzger v. Commissioner, 88 T.C. 834 (1987), *aff'd. without opinion,* 845 F.2d. 1013 (3rd Cir. 1988) (college professor sued for breach of contract, sex discrimination, and national origin discrimination; amount of settlement representing nonwage claims was held excludible).

111. Norfolk & Western Ry. Co. v. Liepelt, 444 U.S. 490 (1980).

112. The Federal Tort Claims Act of 1946, ch. 753, 60 Stat. 842, *codified as amended in* 28 U.S.C. § 2671-80. *See* Hollinger v. U.S., 651 F.2d 636 (9th Cir. 1981).

injury, even if nonphysical harm is being compensated. In the area of traditional common law tort causes of action, plaintiffs have been permitted to exclude awards and settlements received in a variety of nonphysical cases, including suits for invasion of privacy,[113] infliction of emotional distress,[114] intentional torts of assault and battery,[115] alienation of affection,[116] and wrongful death.[117] Among the more recent cases involving nonphysical injuries, the most controversial has been defamation, which in most states is either a common law cause of action under tort doctrine, or a statutorily-based tort claim derived from the common law.[118]

The dispute over the proper treatment of defamation awards has centered on the extent to which a settlement or judgment is a substitute for income. In *Roemer v. Commissioner*,[119] the Service and the Tax Court agreed that defamation of *personal* reputation is an action within the Section 104 exclusion, but that suits for defamation of *business* reputation are outside the statute.[120] The Ninth Circuit, reversing the Tax Court, concluded that as long as a suit is grounded in tort it fits within the definition of "personal injury," particularly because defamation of an individual necessarily is "personal" in some sense.[121] The Tax Court's exploration of the "income substitute" concept in cases involving lost business profits from nonphysical injury could, by its implications, have transformed the analysis in cases of physical harm. But the Tax Court re-examined the issue of lost earnings in *Threlkeld*, and adopted for both physi-

113. *See, e.g.*, Douglass v. Hustler Magazine, Inc., 769 F.2d 1128 (7th Cir. 1985). *Cf.* Starrels v. Commissioner, 304 F.2d 574, 576 (9th Cir. 1962) (payments received for consensual invasion of privacy are includible).

114. *See, e.g.*, Seay v. Commissioner, 58 T.C. 32, 40 (1972), *acq.*, 1972-2 C.B. 3; Rev. Rul 69-212, 1969-1 C.B. 34 (amounts paid to victims of Nazi persecution excludible).

115. *See* Treas. Reg. § 1.104-1(c) ("tort or tort-type" rights).

116. Rev. Rul. 74-77, 1974-1 C.B. 33.

117. *See* Brown v. U.S., 615 F. Supp 391 (D. Mass. 1985); Morgan Guaranty Trust Co. v. Texasgulf Aviation, 604 F. Supp. 699 (S.D.N.Y. 1985). The IRS has taken the position that amounts recovered under a wrongful death statute allowing only punitive damages would not be excludible. *See* Rev. Rul. 84-108, 1984-2 C.B. 32.

118. *See* Threlkeld v. Commissioner, 87 T.C. 1294 (1986), *aff'd*, 848 F.2d 81 (6th Cir. 1988); *Roemer*, 79 T.C. 398 (1982), *rev'd*, 716 F.2d 693 (9th Cir. 1983).

119. 79 T.C. 398 (1982), *rev'd*, 716 F.2d 693 (9th Cir. 1983).

120. *Id.*

121. *Roemer*, 716 F.2d at 700.

cal and nonphysical injury cases an approach that is consistent with the exclusion of human capital values.

B. *The "Business" vs. "Personal" Injury Problem*

In *Glenshaw Glass*,[122] the case that held punitive damages for fraud and the punitive portion of antitrust damages includible in a corporate plaintiff's gross income, there was no issue as to the nonpunitive one-third of an antitrust settlement because the plaintiff treated the compensatory part as ordinary income.[123] The compensatory part of the antitrust award represented lost business profits that would have been taxable if received in the ordinary course. At issue was includability of punitive damages in the nature of windfalls. In *Glenshaw*, the Court described the plaintiffs' treatment of the nonpunitive portion with approval and relied upon the correctness of including the compensatory damages in reaching its holding that the punitive award was also includible: "It would be an anomaly . . . to say that recovery for actual damages is taxable but not the additional amount extracted as punishment for the same conduct which caused the injury."[124]

In *Raytheon Production Corp. v. Commissioner*,[125] the First Circuit stated unequivocally, eleven years before the Court's decision in *Glenshaw*, that "recoveries which represent a reimbursement for lost profits are income [because] the profits would be taxable income [and so] the proceeds of litigation which are their substitute are taxable in like manner."[126] This idea, well-grounded in precedent at the time of the *Raytheon* decision, appears to have been accepted by the *Glenshaw* Court.[127] Yet the "substitute for ordinary income" theory was

122. 348 U.S. 426 (1955).

123. The allocation method, approved by the Tax Court, 18 T.C. 860, 870-72 (1952), was not an issue in the Supreme Court, *Glenshaw Glass*, 348 U.S. at 426.

124. *Glenshaw Glass*, 348 U.S. at 431. It may be that the Court's use of the term "anomaly" to describe different treatment of the compensatory and noncompensatory damages in *Glenshaw* stimulated in part the Service's conclusion, in Rev. Rul. 75-45, 1975-1 C.B. 47, that the punitive portion of damages for "personal injuries" was excludable under Section 104(a)(2) along with the compensatory portion. That result, however, seems inappropriate in light of the other reasons for including punitive damages in income, and the Service subsequently reversed its position in Rev. Rul. 84-108, 1984-2 C.B. 32.

125. 144 F.2d 110 (1st Cir.), *cert. denied*, 323 U.S. 779 (1944).

126. *Id.* at 113.

127. *Glenshaw Glass*, 348 U.S. at 431. *See also* Farmers' & Merchants' Bank v. Commissioner, 59 F.2d 912 (6th Cir. 1932).

not applied to the portion of a compensatory award for personal injury that represented lost earnings. This difference in outlook is not explained in the statutory exclusion or its legislative history, which is ambiguous on the excludability of amounts that substitute for lost profits.[128]

Part of the explanation for the courts' certainty on the issue of "lost business profits" is that suits by a corporation for contract fraud or antitrust damages are not readily thought of as relevant to claims for "personal injuries" within the statutory exclusion. The compensatory part of a lost business profits award posed problems for the courts only because taxpayers argued that some portion of the compensatory award represented a return of basis. In *Raytheon*, for example, the taxpayer argued that its business had been destroyed by the anticompetitive conduct of the defendant, and so the settlement should be treated as a tax-free return of basis, rather like a sale of the business.[129] The *Raytheon* court agreed with the taxpayer's reasoning and would have allowed the taxpayer to reduce the gross amount of the award by the company's "basis," or cost, for business goodwill; but the taxpayer had not proved that it had a basis, so the entire award was held includible.[130]

In *Roemer v. Commissioner*,[131] the Tax Court extended to an individual's tort recovery the principle that damage awards for lost business profits are a substitute for ordinary income and therefore includible. The Tax Court has since revised its position,[132] but the Service has not acquiesced. The plaintiff in *Roemer* was an insurance broker who sued a credit reporting agency for defamation. The plaintiff proved that the agency's false report had damaged his existing business and impaired his ability to attract new clients. He was denied a license to sell

128. *See* Roemer v. Commissioner, 79 T.C. 398 (1982), *rev'd*, 716 F.2d 693 (9th Cir. 1983).

129. *Raytheon Prod. Corp.*, 144 F.2d at 114-15.

130. *Id.* In actions by business entities, punitive damages presented difficulties only because early court definitions of "gross income" used restrictive language: "gain derived from capital, from labor, or from both combined." Eisner v. Macomber, 252 U.S. 189, 207 (1920); Doyle v. Mitchell Bros., 247 U.S. 179 (1918); Stratton's Independence, Ltd. v. Howbert, 231 U.S. 399, 415 (1913). Once the courts overcame this semantic hurdle, the punitive part of recoveries in lost profits cases also was regarded as includible. *See Glenshaw*, 348 U.S. at 431.

131. 79 T.C. 398 (1982), *rev'd*, 716 F.2d 693 (9th Cir. 1983).

132. Threlkeld v. Commissioner, 87 T.C. 1294 (1986), *aff'd*, 848 F.2d 81 (6th Cir. 1988).

casualty insurance, so he was unable to expand his insurance business.[133] The Tax Court pursued the question, "In lieu of what were the damages awarded?" The court reasoned that the "origin and character of the claims" would determine whether the jury's compensatory award was includible.[134]

The taxpayer in *Roemer* argued that a defamed plaintiff's personal and business reputations are inextricably entwined, and therefore, the entire award should be regarded as within the Section 104(a)(2) exclusion.[135] The Tax Court subsequently adopted this analysis in its 1986 decision in *Threlkeld v. Commissioner*.[136] But in *Roemer*, the Tax Court (conceding that the defamation claim was based on "tort or tort-type rights" in the language of the Treasury regulation)[137] concluded that the "predominant nature" of the claim was injury to the plaintiff's business reputation[138] In *Threlkeld*, the Tax Court reversed *Roemer*, saying that it will no longer distinguish between "personal" reputation and "business" reputation for Section 104(a)(2) purposes.[139]

In the *Threlkeld* decision, the Tax Court has emphatically rejected *Roemer* and its implications in physical harm cases.[140] The Tax Court's *Threlkeld* decision expressly adopts the rationale of the Ninth Circuit's reversal in *Roemer*.[141] A key part of the analysis is the idea that, in both physical and nonphysical injury cases, "lost income" is only a measure of the harm rather than the thing being replaced.[142] "[T]he extent to which income is decreased, even though this may be the best measure of the loss, in no way changes the nature of the claim,"[143] the *Threlkeld* court reasoned, echoing the Ninth Circuit's explanation in *Roemer* that "the nonpersonal consequences of a personal injury, such as a loss of future income,

133. *Roemer*, 79 T.C. at 400.

134. *Id.* at 405.

135. *Id.* at 404.

136. 87 T.C. at 1294 (1986), aff'd. 848 F.2d 81 (6th Cir. 1988).

137. 79 T.C. at 405, *citing* Treas. Reg. § 1.104-1(c).

138. The *Roemer* court relied in part on statements by plaintiff's attorney in closing argument: "His lawyer told the jury in his closing statement that the evidence had proved that the petitioner lost $136,000 in prospective income." *Id.* at 406.

139. *Threlkeld*, 87 T.C. at 1304-05.

140. *Id.* at 1299.

141. *Id.* at 1299-1301, *citing* Roemer v. Commissioner, 716 F.2d at 700.

142. *Id.* at 1299.

143. *Id.*

are often the most persuasive means of proving the extent of the injury that was suffered."[144] The idea that anticipated future wages operate as a yardstick to measure the loss of something is consistent with income theory. If a damage award is thought to replace values not usually subject to tax, then it is appropriate to exclude the recovery from gross income. Conceived of as a substitute for imputed (nontaxable) income, rather than as a substitute for ordinary (taxable) income, the payment ought to be excluded.

A difficulty with this analysis is that lost income may be the significant measure of harm. The *Threlkeld* court, adopting an example offered by a dissenter in the Tax Court's *Roemer* decision,[145] points to physical injury cases as the template for analysis: a young surgeon who loses a finger produces evidence of pain, suffering, and lost income. Because it is "easier to place a dollar value upon the loss of future income than upon an intangible such as emotional pain, the surgeon will quite predictably place greater emphasis on lost income as a measure of his damages and will perhaps, thereby, receive a greater recovery."[146] If a jury finds a loss of earnings, is the damage award, as a matter of fact, a substitute for those earnings? In the *Threlkeld* court's view, the conduct causing the severed digit "manifested itself" in the loss of future income,[147] a fact that "raises no troubling questions as to exclusion of the award."[148] Concluding that inconsistent treatment of physical and nonphysical personal injuries would be "analytically irreconcilable," the *Threlkeld* court decided to eliminate the distinction.

This result seems right, but the analysis falters. Theories of income can be used as a frame of reference for evaluating the

144. *Roemer*, 716 F.2d at 699.

145. *Threlkeld*, 87 T.C. at 1300, *citing Roemer*, 79 T.C. at 414 (Wilbur, J., dissenting).

146. *Id.* In contrast, the taxpayer in Church v. Commissioner, 80 T.C. 1104, 1109 (1983), emphasized the great damage that defamation had done to his personal reputation. The Tax Court held the taxpayer's defamation recovery excludible. The plaintiff, a former attorney general of Arizona, had been called a communist in a newspaper editorial. Testimony at trial went to the plaintiff's mental anguish, his "shattered dreams" at the loss of his career in public office, and the humiliation and rejection he suffered as a result of the defamation. No evidence of income loss was offered at trial (perhaps because the defamation caused the taxpayer to move from a government post to a position as an attorney in a private law firm). The Tax Court held that the entire award was for "personal" injuries and therefore excludable.

147. *Threlkeld*, 87 T.C. at 1300.

148. *Id.*

existing system and, where possible, rendering it internally consistent.[149] Tax theory would seem to require inclusion of income substitutes; Section 104(a)(2) could accomodate a rule that treated physical and nonphysical injuries alike, excluding payments for pain and suffering but not payments for lost wages (the "personal" vs. "business" injury distinction in *Roemer*).[150] It is not clear why physical injury of a young surgeon raises "no troubling questions" for the court about exclusion of the lost income part of the award, but it is clear that the court now regards reference to lost future income as compatible with the Section 104 exclusion.

One way to reconcile the courts' interpretation of Section 104 with income theory is to note the emphasis both the Tax Court and the Ninth Circuit place on the measuring function of lost wages.[151] Human capital values — health, mental well-being, intelligence, and productive capacity — can be thought to generate annual imputed income from the use of that capital in the life process. Human capital values, if lost, should be tax-free when replaced; imputed annual income from those values (a year's worth of health, for example) should also be tax-free when "replaced" (payment for the past 12 months of pain and suffering) or when the monetary "equivalent" is received for the first time (payment for 12 months' pain and suffering in the future). The idea that personal earning power, or earning capacity, is a capital value normally not includible in income makes an award for lost earning capacity, or an award measured by anticipated lost income, theoretically consistent with exclusion of payments for pain and suffering.

The Ninth Circuit and the Tax Court both seem to have arrived at the view that "lost earnings" are merely a measure of the loss of human capital values, including (among others) the loss of productive capacity. Although it is possible to view a part of the damage recovery as an income substitute, it seems more correct to say that consideration of lost future earnings is the only way to arrive at a reasonably accurate valuation of the lost nonincludible values. This analysis places Section 104 on a theoretical footing consistent with the courts' refusal to include the part of a damage award measured by lost income; the

149. *See* Andrews, *supra* note 6, at 1178.

150. *Roemer*, 79 T.C. at 404.

151. *Threlkeld*, 87 T.C. at 1299-1301; *Roemer*, 716 F.2d at 699.

refusal to make excludibility turn on whether the "personal injury" is physical or nonphysical; and the refusal to inquire whether the injury is "predominantly" to the personal or to the business persona of the plaintiff. In effect, the courts have established a presumption that recoveries for personal injury represent the replacement of nonincludible human capital values. If Section 104 is read as consistent with the view that Section 61 does not reach human capital values, it is necessary to ask whether human persons can ever suffer harm that is not "personal injury."

C. *The Meaning of "Personal Injury"*

The courts say that whether amounts were paid on account of "personal injuries" depends on "the nature of the claim."[152] The regulations treat "tort or tort-type" claims as claims for "personal injuries."[153] In *Roemer*, the Ninth Circuit held that defamation of an individual was a tort under California law, and therefore a personal injury.[154] In *Threlkeld*, the Tax Court agreed that "the nature of the claim as defined under State law, and the concept of personal injury thereby embodied, are the appropriate criteria" for determining whether a claim is for "personal injury."[155] The court concluded that use of the terms "damages" and "personal injuries" in Section 104 "necessarily implies" that the exclusion depends, "to some degree," on classification of the claim under state law.[156]

There seems to be little doubt, then, that a claim classified as a tort under state law and pursued by an individual will be treated as a claim for "personal injury." But what other claims can qualify for the Section 104 exclusion? And is a plaintiff entitled to the exclusion if state law calls all or part of the claim a tort? In *Roemer*, the Ninth Circuit noted that California's statute provided individuals with a defamation remedy, but that businesses would have to assert a similar claim under a different statutory section with a different statute of limitations.[157] The issue, said the Ninth Ciruit, is whether the damages were

152. *Threlkeld*, 87 T.C. at 1305. *See Roemer*, 716 F.2d at 697.
153. Treas. Reg. § 1.104-1(c).
154. *Roemer*, 716 F.2d at 700.
155. *Threlkeld*, 87 T.C. at 1305-06.
156. *Id.* at 1306 n.6.
157. *Roemer*, 716 F.2d at 699 n.4.

paid on account of "*personal* injuries."[158]

If tort claims are the model for a definition of "personal" injuries, it is not surprising that courts have held constitutional claims pursued under Section 1983 of U.S. Code Title 42 to be "personal" injuries.[159] Constitutional protection of liberties is uniquely associated with the exercise of "natural rights" inherent to the individual.[160] Although in recent years corporate "persons" have been held to have constitutional rights, for example, free speech rights,[161] the "natural law" philosophy in which the constitution has its roots was concerned with the individual's relationship to society.[162] In *Carey v. Piphus*,[163] the U.S. Supreme Court said that Section 1983 was intended to create "a species of tort liability" for deprivation of constitutional rights, and in *Wilson v. Garcia*[164] the Court held that Section 1983 claims were "personal injury" claims for state law statute of limitations purposes. The Tax Court adopted this approach in *Bent v. Commissioner*,[165] holding that a high school teacher's recovery for free speech claims was a recovery for "personal injury" and the settlement payment excludible under Section 104.

The plaintiff in *Bent* was not rehired after he made statements criticizing a school administrator. He brought suit based on both alleged violations of his first amendment rights and breach of his employment contract. The trial court found for the plaintiff on the constitutional claim, and the case was

158. *Id.* at 697 (emphasis in original).

159. *See, e.g.*, Bent v. Commissioner, 87 T.C. 236 (1986), *aff'd.* 835 F.2d 67 (3d Cir. 1987) (first amendment claims). *Cf.* Wilson v. Garcia, 471 U.S. 261 (1985) (characterizing Section 1983 claims as personal injury actions for statute of limitations purposes).

160. *See, e.g.*, L. TRIBE, AMERICAN CONSTITUTIONAL LAW 560-86 (2d ed. 1988); P.S. ATIYAH & R. SUMMERS, FORM AND SUBSTANCE IN ANGLO AMERICAN LAW 222-39 (Clarendon Press 1987). *Cf.* McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316, 403-04 (1819). The natural law tradition presumed a higher-order law than positive (written-down) law, to which reference could be made to resolve ambiguities in positive law, and was concerned with the individual's responsibility to society. Natural rights theory ("life, liberty, and property") was concerned with rights the individual retained despite the organization of individuals into a society. The set of "rights" courts articulate may change over time, but the notion of inherent individual rights is deeply woven into american constitutional doctrine.

161. First National Bank of Boston v. Bellotti, 435 U.S. 765, 783 (1978).

162. *See* authorities cited *supra* note 161.

163. 435 U.S. 247 (1978).

164. 471 U.S. 261 (1985).

165. 87 T.C. 236 (1986), *aff'd.* 835 F.2d 67 (3d Cir. 1987)

settled after briefs were submitted on the damages issue. The plaintiff's brief offered evidence of wage loss, but also alleged "pain, suffering, humiliation, mental anguish and disruption of career plans engendered by the non-renewal [of employment] for an unconstitutional reason."[166] Despite the employment context, the Tax Court decided that the plaintiff's constitutional claim, pursued under Section 1983, was an action for redress of personal injury, and the settlement therefore excludable.[167] This result is consistent with a theory of excludibility of recoveries for loss of human capital and the imputed income arising from it.

If constitutional claims arising from events in an employment context can give rise to a recovery treated as compensation for loss of nonincludible values, may employment discrimination claims under Section 2000 of U.S. Code Title 42 be viewed as actions for restoration of something other than includible income? The primary element of a monetary award for employment discrimination is back pay. But to some extent, a discrimination claim is like a constitutional claim: plaintiff seeks restoration to the nontaxable state of being free from discrimination. Although income theory would require inclusion of a recovery if the damages are intended to substitute for wages the plaintiff did not receive, the countervailing idea that lost wages are merely a measure of loss has prevailed in the tort and constitutional settings. It may be appropriate to presume that employment discrimination recoveries should be excluded because back pay measures the loss of imputed income arising from the nonincludible capital value of a discrimination-free work environment.

The issue may be restated as whether discrimination in the workplace causes damage to human capital. Some economic thought suggests that sex discrimination, for example, causes a decline in personal earning power that may be regarded as a

166. *Id.* at 242.

167. *Id.* at 249 (citing Carey v. Piphus, 435 U.S. 247, 253 (1978) (Section 1983 intended to create "a species of tort liability" for deprivation of Constitutional rights); Wilson v. Garcia, 471 U.S. 261 (1985) (statute of limitations for Section 1983 claim based on state statute of limitations for tort claims); *see also* Herrera v. Valentine, 653 F.2d 1220 (8th Cir. 1981) (analyzing extent to which the Fourth Amendment and Section 1983 create tort-type rights on which recovery may be based even though jury rejected plaintiff's state law tort claims).

loss of human capital.[168] The *Threlkeld* opinion is consistent with this view; the court held that the Section 104 exclusion should apply to compensatory damages received "on account of any invasion of rights that an individual is granted by virtue of being a [human] person in the sight of the law."[169] The court's conclusion was bolstered by the tort claim at issue in *Threlkeld*, a malicious prosecution claim that, under Tennessee law, was an action for injuries resulting from "invasions of rights that inhere in man as a rational being."[170]

The idea that the statutory term "personal injury" refers to claims based on an individual's inherent human rights provides a basis for distinguishing between, for example, workplace discrimination claims and claims based solely on breach of employment contract. The Tax Court's decision in *Bent* made an effort to distinguish the Section 104 treatment of first amendment and breach of contract claims, allowing exclusion of the settlement amount because the plaintiff's breach of contract claim failed and his free speech claim succeeded.[171] The Tax Court drew a similar distinction in *Metzger v. Commissioner*,[172] where a college professor's settlement of claims against her employer was allocated fifty percent to breach of employment contract claims and fifty percent to "all other claims," including discrimination on the basis of sex and national origin. In *Thompson v. Commissioner*,[173] the taxpayer was allowed to exclude "liquidated damages" awarded under the federal Equal Pay Act for gender-based pay discrimination, but was required to include an identical sum called a back pay award; it was said to be like an award of wages due for an action in the nature of breach of contact. The theory-based distinction, however, is

168. *See* Hartog, *An Ordered Response Model for Allocation and Earnings*, 41 KYKLOS 113, 139 (Appendix 2) (1988); Egge & Bunting, *How to Divide Human Capital Assets*, TRIAL 27, 28-29 (Aug. 1985).

169. *Threlkeld*, 87 T.C. at 1308. In dictum, the court expressly rejected the idea that a corporation could claim the personal injury exclusion. *Id.* at 1308 n.7.

170. The *Threlkeld* court quotes Brown v. Dunstan, 219 Tenn. 291, 409 S.W.2d 365, 367 (Tenn. 1966) (quoting Commerce Oil Refining Corp. v. Miner, 98 R.I. 14, 199 A.2d 606 (R.I. 1964)). *Threlkeld*, 87 T.C. at 1307.

171. *Bent*, 87 T.C. at 236, 249-50, *aff'd.* 835 F.2d 67 (3d Cir. 1987).

172. 88 T.C. 834, 858 (1987), *aff'd without opinion* 845 F.2d. 1013 (3d Cir. 1988). Reliance on state law definitions of tort and contract will produce inconsistencies in the treatment of similarly situated taxpayers who live in different states. *See* Cochran, *supra* note 8.

173. 89 T.C. 632 (1987), considering awards under the Equal Pay Act, 29 U.S.C. § 206(d).

not between "tort or tort-type claims" and claims based in contract law, but between claims for loss of human capital values and claims for losses that ordinarily are measured in market terms.

D. *Allocation Problems*

Not all judgments and settlements are allocated neatly between includible and excludible values. The Tax Court pointed out in *Threlkeld* that state law may be "of limited assistance" if a case is settled and more than one claim is involved or the claim is unclear.[174] *Threlkeld* concluded that "carving up the damage recovery" will be necessary where some of the claims are not "personal injury" claims.[175] *Bent*, decided before *Threlkeld*, suggests that allocation is appropriate; *Metzger*, decided after, makes it clear that the Tax Court will scrutinize a settlement to separate out includible damages from excludible "personal injury" recoveries.

Is it consistent with income theory to treat employment contract damages differently from other claims against an employer? Yes. In the language of the decided cases, breach of an employment contract violates rights that can be vindicated under the law, but a contract claim is not based on rights an individual has "by virtue of being a person in the sight of the law."[176] Contract rights do not "inhere" in the individual, but are created by consent.[177] From an income theory point of view, an individual's right to wages under an employment con-

---

174. *Threlkeld*, 87 T.C. at 1306.

175. *Id.* The Tax Court would allocate a settlement between "personal injuries" for Section 104 purposes and other claims by looking to "various factors, including the allegations in the State court pleadings, the evidence adduced at trial, a written settlement agreement, and the intent of the payer." *Id.* at 1306.

In many states, the jury must state separately the past and future awards for different kinds of issues, including noneconomic loss (pain, disability, and disfigurement); economic loss (medical expenses, loss of earnings, and loss of earning capacity); and intangible loss (embarrassment, emotional distress, and loss of consortium). *See* authorities cited *supra*, note 60.

176. *Threlkeld*, 87 T.C. at 1308.

177. Contract rights exist only after the formation of the contract, although contract-like rights can be created by quasi-contract rules. A contract usually comes into being after an offer is accepted, a consensual act that creates the legal relationship. *See* CORBIN, CORBIN ON CONTRACTS § 2 (One Volume Edition, 1952) ("If a legal right exists, it is a right against some person who is under a duty to the one having the right"); *see also* FARNSWORTH, CONTRACTS § 3.4 n.2 (1982). Thus, contract rights are thought of as created by individuals, rather than inherent to them.

tract, like a landlord's right to rent under a lease, is a right to collect values ordinarily measured in market terms. A payment for release from the employment contract, without the assertion of other claims, would seem to be purely an includible income substitute.[178] In contrast, a recovery of damages for invasion of nonincludible values — physical and mental wholeness, free speech, freedom from racial discrimination, freedom from sex harrassment — is a substitute for values that traditionally are excluded from gross income. The courts' recent series of conclusions and distinctions seem remarkably consistent with the theory that human capital values are outside the economic definition of income. The concept of human capital as a nonincludible value from which individuals ordinarily derive nonincludible income offers a theoretical base from which to achieve systematic and consistent tax treatment of damage recoveries.[179]

CONCLUSION

Critics rightfully carp at the tax code's complexity and inconsistency. Congress has certainly never felt bound to carry out an articulated definition of income. Nor have the courts been particularly attuned to formal economic definitions. Nonetheless, it often seems that courts and Congress act from an intuitive economic sense that turns out to be remarkably consistent with formal definitions — adjusted, of course, for administrative and social policy goals inevitably present in a political society. This intuition may be at work in the courts' development of the law of personal injury damage recovery taxation.

It is easy to see why in *Roemer* the Tax Court regarded the defamed taxpayer's recovery as an includible substitute for income. The states' reference to lost earnings as a tool for deter-

178. *Cf.* Hort v. Commissioner, 313 U.S. 28, 32 (1941).

179. Damages representing compensation for medical expenses are excludible, but the plaintiff may not also take a Section 213 medical expense deduction. Section 104 makes includible that part of a damage award attributable to previously-deducted medical expenses. Future medical expenses are not deductible until they exceed the amount of the recovery for medical expenses. If the judgment or settlement identifies an amount representing future medical expenses, this allocation will be respected if it is reasonable. In the absence of an allocation, the Service had not denied Section 213 deductions for future medical expenses, but reversed this position in Niles v. Unites States, 520 F. Supp. 808 (N.D. Cal. 1981), *aff'd*, 710 F.2d 1391 (9th Cir. 1983), where the Service argued that a reasonable allocation should be made. The Ninth Circuit disagreed, refusing to make an allocation for the parties.

mining the extent of plaintiff's injury invites the conclusion that the recovery must be an income substitute. The persistent view of the recovery as analogous to a return of market capital, but without an identifiable tax-paid basis, in particular seems to compel the conclusion that lost "profits" are includible. The Ninth Circuit's reversal in *Roemer*, relying as it did on a doctrinal interpretation of defamation as a tort claim and therefore a "personal injury," did not clearly signal a new way of thinking about damage recovery taxation. The Tax Court's thoughtful response in *Threlkeld* reflects a change in perspective on the exclusion of personal injury damages.

The tax system's treatment of human capital as a value outside market measures of income has been approved[180] and criticized.[181] But until the tax law is altered to require systematic inclusion of values taxpayers now enjoy tax-free, it seems inappropriate to include replacements for those values, regardless of the measure states use to quantify plaintiff's loss. The *Roemer-Threlkeld* picture of lost earnings as a yardstick rather than an injury is, at a minimum, reasonable. That it is consistent with income theory makes this particular aspect of the law's development persuasive.

Less satisfying is the courts' doctrinal approach to the definition of "personal injury." The tort analogy works as a rule of thumb because everybody understands that a punch in the nose is personal. But at the margin, where injury to human capital and market capital both lie in tort and are difficult to separate, the tort analogy is barren. Moreover, rigid adherence to state law definitions of "tort" or "personal injury" is anathema to a federal income tax grounded in notions of equity. It seems far better to free the Section 104 definition from doctrinal bounds, and instead use the idea of human capital as the touchstone for exclusion of damage recoveries.

180. *See* McIntyre and Oldman, *supra* note 18.
181. *See* Stephan, *supra* note 24.